2011 TAX UPDATE

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2011

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2011 TAX UPDATE
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YEAR 2011 INDIVIDUAL FEDERAL TAX UPDATE

CHAPTER HIGHLIGHTS

- ***New!*** Rates Stabilized for 2011 and 2012
- ***New!*** Community Property Rules Impact Registered Domestic Partners Returns
- ***New!*** Health Bill Brings Major Tax Changes in the Next 8 Years
- ***New!*** Medical Benefits for Children Under 27 Permitted
- ***New!*** Over-the-Counter Medicines From Health Accounts Limited Starting in 2011
- ***New!*** Additional Medicare Tax for High Income Taxpayers Begins in 2013
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WHAT'S NEW FOR 2011 INDIVIDUAL RETURNS

THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010

On December 17, 2010, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312)." The law is a compromise with provisions that some like and some dislike. What is the best part of the legislation? It's the law and that means tax preparers/planners are finally back in business. The 2010 Tax Relief Act contains temporary extensions of the Bush tax cuts, an AMT patch, a partial extender bill for expired 2009 provisions, temporary estate tax relief, and temporary extensions of some business tax relief.

Temporary Extension of Tax Relief

Two major bills enacting tax cuts for individuals expired at the end of 2010: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The 2010 Tax Relief Act extends these provisions from EGTRRA and JGTRRA for an additional two years, through 2012. The new law also extends a number of provisions enacted as part of EGTRRA that were modified in the American Recovery and Reinvestment Act of 2009.

Individual Income Tax Rates Same for 2010, 2011 and 2012

Temporarily extends the 10% bracket. The 10% individual income tax bracket expired at the end of 2010. Upon expiration, the lowest tax rate was due to increase to 15%.The 2010 Tax Relief Act extends the 10% individual income tax bracket for an additional two years, through 2012.

Temporarily extends the 25%, 28%, 33%, and 35% brackets. The 25%, 28%, 33%, and 35% individual income tax brackets expired at the end of 2010. Upon expiration, the rates were due to increase to 28%, 31%, 36%, and 39.6% respectively. The 2010 Tax Relief Act extends the 25%, 28%, 33%, and 35% individual income tax brackets for an additional two years, through 2012.

Planning point. The extension of the Bush tax cuts for two years means that clients can plan between years without worrying about tax rate changes. If income and deductions are about the same in 2010, 2011 and 2012, the tax burden will be similar between the years. A big tax bill will not hit our clients because of law change.

Planning point. Choosing to report income from a 2010 Roth IRA conversion in 2011 and 2012 is more attractive now that we know the tax brackets will be the same in 2011 and 2012 as those in 2010.

Planning point. With the increase in tax rates postponed until 2013, a 2011 and/or a 2012 Roth IRA conversion may be attractive.

Planning point. 2011 estimated tax payments can more reliably be based on the 2010 safe harbor amounts now that we know 2011 taxes will be similar to 2010.

2011 Tax Rates		
single	married filing joint	tax rate
$0 - $8,500	$0 - $17,000	10%
$8,500 - $34,500	$17,000 - $69,000	15%
$34,500 - $83,600	$69,000 - $139,350	25%
$83,600 - $174,400	$139,350 - $212,300	28%
$174,400 - $379,150	$212,300 - $379,150	33%
$379,150	$379,150	35%

A Quick Look at Expiring Provisions		
IRC	**Provision**	**Expiring**
41	Research and Experiment credit	12-31-2011
55(c)	AMT reduced by non-refundable credits	12-31-2011
55(d)	AMT exemption amount	12-31-2011
62	$250 teacher deduction	12-31-2011
164	Sales tax in lieu of state income tax	12-31-2011
168	15-year recovery period for leasehold improvements and restaurant improvements	12-31-2011
168	First year additional depreciation (100%)	12-31-2011
168	First year additional depreciation (50%)	12-31-2012

170	Enhanced deduction for corporate contributions of scientific property to schools	12-31-2011
170	Enhanced deduction for business contributions of food, books, and inventory.	12-31-2011
222	Tuition deduction	12-31-2011
408(d)(8)	IRA transfer to charity	12-31-2011
2010	$5 million estate tax exemption	12-31-2012

A Quick Look at New Provisions for 2011	
IRC	Provision
52	$1,000 employee retention credit from HIRE Act available in 2011 for eligible 2010 new hires who work more than 52 weeks
72(a)(2)	Partial annuitization allowed for non qualified contracts, annuities or life insurance contracts
106(f), 220(d)(2)(A), 223(d)(2)(A)	Cost of over the counter medicines cannot be reimbursed by FSA, HSA, HRA or MSA
220(f)	Non qualified distributions from FSA, HSA, HRA or MSA are subject to 20% penalty
125(j)	Small C Corporations may establish "Simple" cafeteria plans.
6045(g)	Form 1099B basis and character reporting begins for purchases after 12-31-10
6050W	Form 1099K begins for credit card and third-party merchant payment transactions
	2% reduction in FICA and SE tax applies

FILING STATUS

Married Filing Joint vs. Single

Is marriage out of date for the wealthy? This topic has lots of complexities but the tax code imposes more tax on married couples than singles. Marriage penalties abound. Top tax rates hit at the same taxable income for single and joint returns. The new Medicare tax on investment income applies at $200,000 single and $250,000 joint. Should the CPA include a comparison of single versus married filing joint with a tax plan? With a retirement plan? Should a couple stay single and just say to family and friends that they are married?

Registered Domestic Partners (RDPs)

RDPs included in community property Pub. Publication 555, community property, was modified March 1, 2011 to clarify that it applies for community property issues of registered domestic partners (RDPs) who are domiciled in Nevada, Washington, or California and for individuals in California who, for state law purposes, are married to an individual of the same sex.

Use community property rules in 2010. For 2010, an RDP in Nevada, Washington, or California (or a person in California who is married to a person of the same sex) generally must follow state community property laws and report half the combined community income of the individual and his or her RDP (or California same-sex spouse). These rules apply to RDPs in Nevada, Washington, and California in 2010 because they have full community property rights in 2010. California RDPs attained these rights as of January 1, 2007. Nevada RDPs attained them as of October 1, 2009, and Washington RDPs attained them as of June 12, 2008.

May amend years prior to 2010. For years prior to 2010, RDPs who reported income without regard to the community property laws may file amended returns to report half of the community income of the RDPs for the applicable periods, but are not required to do so. If one of the RDPs files an amended return to report half of the community income, the other RDP must report the other half.

Other items of interest. The new IRS publication says that RDPs may not split estimates. Each must make their own but withholding is split. Division of property in a divorce is not taxable for opposite sex couples but can be taxable for RDPs.

Community Property Reporting

RDPs and community property income. In May 2010 IRS Chief Counsel issued two new CCAs regarding the division of income, deductions and withholding for California's registered domestic partners (RDPs) on their federal income tax returns. (CCA 201021048 and CCA 201021050).

What is community income? In a recent Tax Court case, the definition of community property income is detailed. Micka Oliver was married to Baron Oliver, but elected to file married filing separate. Both Micka and Baron lived in Arizona, a community property state. The issues were: (1) to what extent, if any, must Micka include in her income wages, unemployment compensation, dividends, and Social Security benefits Baron received in the years at issue; (2) to what extent, if any, must Micka include the interest income that the Olivers jointly received in 2001 and 2002 and the gain on the sale of stock the Olivers jointly received in 2002; (3) to what extent, if any, must Micka include the proceeds the Olivers jointly received in 2002 pursuant to a personal injury settlement agreement; (4) to what extent, if any, must Micka include Social Security benefits she received during the tax years at issue; and (5) to what extent, if any, must Micka include the proceeds from the sale of real estate in 2004. (*Micka M. Oliver V Comm. Pro Se*, TCM 2011-43)

Same-Sex Couples Allowed to File Joint Returns? (*Nancy Gill et. al., v. Office of Personnel Management et. al.*, 2010-2 USTC ¶50,509)

Historically, the marital status of individuals as determined under state law was recognized for federal tax law purposes (Rev. Rul. 58-66). In 1996, the Defense of Marriage Act (DOMA) made two changes in this area: 1) for federal law purposes, "marriage" was defined as a legal union between one man and one woman,

regardless of state law; and 2) it provided that states, territories, possessions and Indian tribes were not required to recognize same-sex marriages that were legally entered into under laws from other states, territories, possessions or Indian tribes. As a result of the DOMA, same-sex couples are not allowed to use the married joint or married separate filing status.

Massachusetts couple takes on Defense of Marriage Act. Nancy Gill and Marcelle Letourneau were legally married under Massachusetts law. Nancy, a US Postal Service employee, requested to include Marcelle in several employment related benefits made available to spouses of federal employees (i.e., health benefits, FSAs, survivor benefits, etc.) but, because of DOMA, her requests were denied. The couple joined with several other same-sex couples and filed suit not only to get employment related benefits for same-sex spouses but also to allow same-sex couples to file joint federal income tax returns and participate in spousal Social Security programs.

Federal Judge Rules Defense of Marriage Act unconstitutional. Judge Joseph Tauro, ruled that DOMA violated the equal protection clause of the 5th Amendment, and, therefore, was unconstitutional. Furthermore, he noted that there was no rational relationship to a legitimate government objective and that Congress's stated reasons for enacting DOMA essentially created a second class of people. Judge Tauro said "the Constitution neither knows nor tolerates classes among citizens and that it is with this fundamental principle in mind that the equal protection takes on governmental classifications that affect some groups of citizens differently than others. It is because of this commitment to the law's neutrality where the rights of persons are at stake that legislative provisions which arbitrarily or irrationally create discrete classes cannot withstand constitutional scrutiny."

Okay, now what do we do? Regardless of marital status, same-sex couples are not allowed to use the married joint or married separate filing status. It is a virtual certainty that the Gill case will be appealed and most likely decided by the US Supreme Court. In the meantime, it appears that the IRS will continue to deny same-sex couples the married joint or married separate filing status. Tax preparers with clients in this situation should consider filing protective claims for all open years. For future filings, preparers who choose to file joint or separate returns for same-sex couples should also attach Form 8275, Disclosure Statement, to the return and the client should be informed of the potential audit risk.

PERSONAL EXEMPTIONS AND DEPENDENTS §151 - 153

The 2011 Personal Exemption is $3,700 (Rev. Proc. 2011-12)

Personal Exemption Phase-out is Phased-out for 2011 and 2012 (The Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312))

Everybody gets $3,700 personal exemption in 2011 and 2012! EGTRRA contained a five-year phase-in of the repeal of the personal exemption phase-out. Under the five-year phase-in, the otherwise applicable personal exemption phase-out was reduced by one-third in taxable years beginning in 2006 and 2007, and is reduced by two-thirds in taxable years beginning in 2008 and 2009. The repeal is fully effective for taxable years beginning after December 31, 2009 and has been extended through December 31, 2012 by the Tax Relief Act of 2010 (§151(d)(3)(E)).

Child Tax Credit

Temporarily extends the modified child tax credit through 2012. Generally, taxpayers with income below certain threshold amounts may claim the child tax credit to reduce federal income tax for each qualifying child under the age of 17. The EGTRRA increased the credit from $500 to $1,000. The EGTRRA also expanded refundability to 15% of earnings above $10,000. The American Recovery and Reinvestment Act of 2009 provided that earnings above $3,000 would count toward refundability but only for 2009 and 2010. The 2010 Tax Relief Act extends the current child tax credit for an additional two years, through 2012.

> **Planning point**. The child tax credit begins to phaseout when AGI exceeds $110,000 MFJ and $75,000 single and head of household.

DEFINITION OF A QUALIFYING CHILD AND QUALIFYING RELATIVE

For an Individual to Be Considered a "Qualifying Child," Five Tests Must Be Satisfied (Emergency Economic Stabilization Act of 2008

1. **Child must be related to taxpayer** §152(f)(1)).
2. **Age**. The child must not have attained the age of 19 by the end of the calendar year or must be a student that has not attained the age of 24 by the end of the calendar year (§152(c)(3) and (f)(2)). Starting in 2009, a qualifying child must be younger than the taxpayer (§152(c)(3)(A)). Therefore, a taxpayer's older brother or sister cannot be the taxpayer's qualifying child. Exceptions to this requirement exist for any individual who is totally and permanently disabled at any time during the year.
3. **Child must have same principal place of abode as taxpayer for more than ½ of year** (§152(c)(1)(B)).
4. **Child must not provide more than ½ of his or her support for year** (§152(c)(1)(D)).
5. **Joint return restriction**. Starting in 2009, the child must not have filed a joint return (other than for a claim of refund only) with a spouse for any tax year beginning in the calendar year in which the taxpayer's tax year begins (§152(d)(1)(E)).

> **Comment.** Previously, a taxpayer with a qualifying child who filed a joint return lost the dependency exemption, but not the other tax benefits of a qualifying child (§152(b)(2)). The new test #5 expands the restrictions to all code sections using the term "qualifying child."

- *Virginia Bobo v. Comm.*, TCM 2010-121, 54-year-old totally and permanently disabled sister is a qualifying child, lived with Virginia more than half the year, did not provide more than half of her own support, and did not file a joint return. (There is no explanation why the IRS overlooked the disabled exception to the age test in this case.)
- *Genise A. Conner v. Comm.*, TSC 2010-8, Aunt could claim niece as niece was under 19, was a high school student with no income and lived with Aunt for entire year.
- *Lee Edward Elverson v. Comm.*, TCS 2010-36, accountant denied exemption for 22-year-old daughter as there was no evidence that she was a student and her gross income exceeded the $3,000 exemption amount.

Definition of "Qualifying Relative"

Individuals not qualifying as a "qualifying child" may still be claimed as a dependent if four similar tests are satisfied (§152(d)):

1. ***The relative must be related to the taxpayer*** §152(f)(1)) ***OR***:
   A Be an individual that for the tax year has the same principal place of abode as the taxpayer and is a member of the taxpayer's household[1] (§152(d)(2)).
   Note: These relationships do not include cousins.
2. ***Gross income***. The individual's gross income for the calendar year must be less than $3,650 ($3,700 in 2011) [§152(d)(1)(B)].
3. ***Support***. The taxpayer must furnish over half of the dependent's total support for that calendar year (§152(d)(1)(c)).
4. ***Dependency***. The individual must not be the qualifying child of the taxpayer or of any other taxpayer for the tax year (§152(d)(1)(D)). When the "other taxpayer" is not required to file an income tax return, and does not file an income tax return, or files an income tax return solely to obtain a refund of withheld income taxes, the dependent relative may be claimed by another (Notice 2008-5).

Tie-breaking Rules For Qualifying Child (Emergency Economic Stabilization Act of 2008).

With two exceptions, if a child may be claimed as a qualifying child by two or more taxpayers for a taxable year, such individual will be treated as the qualifying child of the taxpayer who is a parent of the individual, or if not a parent, the taxpayer with the highest adjusted gross income for such taxable year (§152(c)(4)(A)(i) & (ii)).

Exception #1. When both parents claim a qualifying child, the child will be treated as the qualifying child of the parent with whom the child resided for the longest period of time during the taxable year, or if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income (§152(c)(4)(B)(i) & (ii)).

> **Preparer Point.** This change reduces the opportunity to claim an EIC by requiring that the qualified child be claimed on the return of the highest paid (unmarried) parent.

Exception #2: Starting in 2009, if the parents of an individual may claim such individual as a qualifying child, but no parent claims the individual, such individual may be claimed as the qualifying child of another taxpayer, but only if the adjusted gross income of the taxpayer is higher than the highest adjusted gross income of any parent of the individual (§152(c)(4)(c))).

- *Barry Mamoudou v. Comm.,* TCS 2010-9, boyfriend can't claim girlfriend's children because he wasn't the natural parent and because the mother was entitled to claim them as qualifying children.
- *Nasser and Bashera Ghaleb v. Comm.*, TCS 2010-46, estranged mother with three children move in with uncle for 10 months, but reconciles by end of year and files jointly with husband/natural father. Even though he provided over 50% of the support, the tie-breaking rules deny uncle from

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[1] Interestingly, this class of "qualified relative" has no family relationship to the taxpayer. However, an individual is not a member of the taxpayer's household if the relationship between the individual and the taxpayer violates local law (§152(f)(3)).

claiming the three children as the natural parent trumps all others. Uncle also can't claim the mother as she filed jointly with her husband. In its ruling, the court told Nasser that even though they were denying his claim for additional dependency exemption deductions and child tax credits, they commended his generosity! Yeah, that helps.

Medical Benefits for Children under 27 (Notice 2010-38)

Insurance companies no longer allowed to used tax dependency rules to determine insurance eligibility (TR §54.9815-2714T). Insurance issuers offering group health insurance coverage that covers dependent children must make such coverage available for children until attainment of 27 years of age. The plan or insurance issuer may not deny or restrict coverage for a child who has not attained age 27 regardless of the child's financial dependency upon the insured, student status, employment, residency with the insured, or any combination thereof.

Transitional rules aid those who have lost or been denied coverage. Any child whose coverage ended, or who was denied coverage, prior to attaining age 27, and who now becomes eligible under the new law, is granted transitional relief. This relief provides that a qualifying child must be given the opportunity to enroll in the health insurance plan for a period that lasts at least 30 days beginning not later than the first day of the plan year beginning on or after September 30, 2010. The child cannot be required to pay more for coverage than others who did not lose coverage due to dependency status.

Exception. For plan years beginning before January 1, 2014, a grandfathered health plan (as defined under §1251 of PPACA) may exclude from coverage an adult child who has not attained age 27 if the adult child is eligible to enroll in an employer-sponsored health plan.

Child under 27 can stay on the parent's health plan; medical insurance premium deductible even when child under 27 is not a dependent. The general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan has been extended, effective as of March 30, 2010, to any child of an employee who has not attained age 27 as of the end of the taxable year. This change is also intended to apply to the exclusion:

- for employer-provided coverage under an accident or health plan for injuries or sickness for such a child;
- of a qualified pension or annuity plan to provide benefits for sickness, accident, hospitalization, and medical expenses to retired employees, their spouses, and their dependents, and
- that treats a voluntary employee benefits association (VEBA) providing sick and accident benefits to its members and their dependents as a tax-exempt organization.

Comment. PPACA requires insurers that provide group health coverage for dependent children to continue such coverage if the dependent is less than 26 years old at the end of the tax year (PHSA Sec. 2714, as added by PPACA, and amended by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152)).

IRS Examples (Notice 2010-38)

1. JB Tools, Inc.'s employer-provided health plan covers its employees, spouses, and dependents under age 26. Sandy's son, Cris, who turns 26 on November 15, 2010, is not her dependent. Prior to the

passage of the PPACA, health coverage extended to non-dependents would create a taxable fringe benefit for Sandy. With this new change, because Cris is not 27, the health coverage extended to a non-dependent qualifies as a tax-free fringe benefit from March 30, 2010 (the effective date of PPACA) through November 15, 2010 (when Cris become 26 and loses coverage under the terms of the plan). The coverage from January 1, 2010 to March 30, 2010 would be a taxable fringe benefit because Sandy could not claim Cris as a dependent (Notice 2010-38, Ex. 1).

2. If JB Tools, Inc's health plan had covered dependents under age 27, the coverage from November 15, 2010 through December 31, 2010 would also qualify as a tax-free fringe benefit, even if Cris worked for another employer and could not be claimed as a dependent by Sandy (Notice 2010-38, Ex. 2).
3. The results would be the same even if Cris's employer provides health coverage but he elects to stay covered under his mother's plan (Notice 2010-38, Ex. 3).
4. If Cris was married and both elected to stay on his mother's plan instead of being covered by Cris's employer's plan, the fair market value of his wife's policy, but not the value of the policy prorated to Cris, would create a taxable fringe benefit for Sandy (Notice 2010-38, Ex. 4).
5. National Car's employer-provided health plan covers its employees, spouses and dependents. On May 1, 2010, National extends coverage to an employee's child under 26. In 2010, National's health plan covers Frank, an employee, and his 22-year-old son Kurt. Kurt graduates from college on May 15, 2010 and thereafter is not a student. From January 1 to May 15, Kurt's health coverage is a tax-free fringe benefit because Kurt is Frank's dependent. Even though no longer Frank's dependent, from March 30 to December 31, Kurt's health coverage is still a tax-free fringe benefit because he is under age 27 in 2010 (Notice 2010-38, Ex. 5).

Self-employed can take advantage of this rule. Self-employed individuals are also permitted, under §162(l) to take a deduction for SE health insurance for any child of the taxpayer who has not attained age 27 as of the end of the taxable year. However, the self-employed may not claim the deduction for the cost of health care insurance if the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of a taxpayer's dependent or a child of the taxpayer who is under 27 at the end of the tax year.

It isn't necessary that a child is really dependent to be a dependent! It is not necessary for the child of the employee to be a dependent of the employee in order for this medical exclusion to apply. If the child is age 26 or less at the end of the tax year, the exclusion applies even when:

- the child provides more than half of his or her own support;
- earns more income than the exemption amount ($3,650 in 2010);
- does not live with the taxpayer; or
- any other restriction applies which would prevent the employee from claiming a dependency exemption for the child either under the qualifying child rules or the qualifying relative rules.

Definition of a child. For purposes of the provision, "child" means an individual who is a son, daughter, stepson, stepdaughter, or eligible foster child of the taxpayer. An eligible foster child means an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

DEPENDENCY RULES FOR CHILD OF A DIVORCED COUPLE

Who is the Custodial Parent After a Divorce? (§152(c); §152(e); T.D. 9408; Final Regulation §1.152-4)

Determination of the custodial parent is decided by a "time" test. A qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (§152(c)(1)(B)). In addition, the parent(s) must have the right under state law to physical custody for more than one-half of the taxable year; e.g., if Grandmother has the right under state law to physical custody of a child from January 1 to July 31, neither parent can use the special dependency rules for divorced parents and only the regular dependency rules will determine if Grandmother or either parent can claim the child (§1.152-4((c); §1.152-4(g), Exp. 3). If both parents of a child claim the child as a qualifying child and do not file a joint return, the child is treated as the qualifying child of the parent with whom the child resides for the longer period of time (i.e., nights over) during the taxable year or, if the child resides with both parents for an equal period of night overs, of the parent with the higher adjusted gross income (§152(c)(4)(B); §1.152-4(a); §1.152-4(d)(4)).

The "counting nights over" rule: custodial parent determined by majority of child's "night overs," not by divorce decree. The custodial parent is the parent with whom the child resides for a greater number of nights during the calendar year. The other parent is designated the noncustodial parent (§1.152-4(d)(1)). This "time" test reverses the prior regulations §1.152-4(b), which stated that "the term 'custody' was 'determined by the terms of the most recent decree of divorce'" (see §1.152-4(b); *Cafarelli v. Comm*., T.C. Memo. 1994-265).

- *Tommy C. Vasquez v. Comm., pro se,* TCS 2010-124, parent with custody for only 103 days is noncustodial parent.

A court order, decree, or separation agreement may not serve as the written declaration (§1.152-4(e)(1)(ii), last sentence; see also CCA 200925041). Starting on July 2, 2008, neither a court order or decree nor a separation agreement, by itself, can serve as a qualified written declaration, although pre-7/2/2008 court orders, decrees, and separation agreements have been grandfathered in and will be treated as meeting all the requirements (§1.152-4(e)(1)(ii), last sentence; §1.152-4(e)(5)). The post-7/2/2008 rule makes sense, as most divorces are from "orders of the court" and signed solely by the presiding judge, and they are not agreements signed by both parents. Rarely does a judicial order contain the signature of the custodial parent.

Allocation of Dependency Exemption in Divorce Decree or Separation Agreement Will Be Rejected by the Court; Must Have Signed Form 8332 (*Mark Antony Mihalick-Jarosak v. Comm. pro se*, TCS 2010-122

How many times have tax preparers seen this! Mark Anthony Milhalick-Jarosak's separation agreement provided:

> *Father shall be allowed to claim the minor child as a dependent and exemption for purposes of state and federal income taxes in the odd numbered years beginning in 2002. Mother shall be allowed to claim the minor child as a dependent and exemption for purposes of state and federal income taxes in the even numbered years beginning in 2002. Father may only claim the minor child as a dependent and exemption when his ($555 per month) child support obligation is current and paid up-to-date. If an arrearage exists, Father will not be entitled to claim the minor child.*

The divorce decree is irrelevant. As Mark was the non-custodial parent, and no signed Form 8332, or its equivalent existed, Mark was not entitled to a dependency exemption with respect to his minor son.

> **Comment.** Not only was the divorce decree irrelevant for determining who can claim the dependency exemption, but since he was behind on his child support payments, why did he think he could claim the children anyway?

- *John D. Thomas v. Comm.,* TCM 2010-11, Sympathetic court holds divorce decree irrelevant, a state judge can't determine a federal deduction, include the dependency deduction. Also see:
- *Gregory and Susanna Clinton v. Comm.,* TCS 2010-75
- *Stephen S. Gessic v. Comm.,* TCM 2010-88
- *Paul E. Hendrickson v. Comm.,* TCS 2010-45

Custodial Parent Can Release Exemption for Child to the Noncustodial Parent

Eligibility requirements to release. If the custodial parent signs a written declaration that the custodial parent will not claim the child as a dependent for any taxable year *and* the noncustodial parent attaches the declaration to the noncustodial parent's return, this releases the custodial parent's claim to the dependency exemption under §152(e), and, therefore, the principal place of abode requirement (see §152(c)(1)(B)), the tie-breaking rule (see §152(c)(4)(B)), and the support rule (see §152(d)(1)(c)), do not apply. But, if a custodial parent does not release the claim to the exemption, then the qualifying child (§152(c)) and qualifying relative (§152(d)) rules still apply. Form 8332 contains the required language to affect this release.

> **Comment.** Joint custody must use the general "night over" custody rules.

- *Allison Lea Mullins v. Comm.,* TCS 2010-108, a noncustodial parent who did not attach signed Form 8332 and was denied the exemption.

Use Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents) for this Purpose

The release must constitute the custodial parent's *unconditional* release of the parent's claim to the child as a dependent for the year or years for which the declaration is effective. A declaration is not unconditional if the custodial parent's release requires the satisfaction of *any* condition, including the noncustodial parent's meeting of an obligation such as the payment of child support.

Release must be attached to noncustodial parent's return. A noncustodial parent must attach a copy of the original written declaration for *each* taxable year in which the child is claimed as a dependent (§1.152-4(b)(3)(i); §1.152-4(e)(2)).

Release Only Transfers Dependency Exemption and Child Tax Credit.

Form 8332 only releases the dependency exemption along with the $1,000 child tax credit and the additional child tax credit (see §24(a), clarified by H.R. 6893 for tax years beginning in 2009).

Comment. The custodial parent may still claim head of household filing status if the dependency exemption is waived and may still claim the earned income credit and dependent care credit, if eligible.

Note. The form 8332 can be revoked. See Part III of the form 8332 and its instructions for guidance.

GROSS INCOME

CAPITAL GAIN AND DIVIDENDS

0% and 15% Rates for Capital Gains and Dividends in 2011 and 2012 (The Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312))

Temporarily extends the capital gains and dividend tax rates. For 2010, the long term capital gains and qualified dividend tax rates for taxpayers below the 25% bracket are zero percent. For those in the 25% bracket and above, the long term capital gains and qualified dividend tax rates are currently 15%. This treatment applies for purposes of both the regular tax and the alternative minimum tax. The 2010 Tax Relief Act extended the 2010 capital gains and dividend rates for all taxpayers for an additional two years, through 2012. These rates are scheduled to expire at the end of 2012. Upon expiration, the rates for long term capital gains are due to increase to 10% and 20%, respectively, and qualified dividends would have been subject to the ordinary income rates.

Tax Bracket	1/1/01 - 5/5/03	5/6/03-2007	2008-2012	2013
10% and 15%	8% /10%	5%	0%	10%
25% and above	20%	15%	15%	20%

Note. No rate reduction occurred on the maximum 25% rate on depreciation recapture, the 28% rate on collectibles and the net gain rules on small business stock. In addition, net capital losses are still subject to the $3,000 limit per year (§1222(b)).

Planning point. The extension of the 0% qualified dividend and long term capital gain rate will allow low income taxpayers (2011 taxable income below $34,500 for a single taxpayer and $69,000 for MFJ taxpayers) two more years to generate "free" capital gain and dividend income.

Planning point. Gifting appreciated stock to adult children or parents in low brackets can be a good plan for utilizing the 0% tax rate.

Planning point. Installment sale proceeds are taxed at the rate in effect in the year the principal is collected. Collections in 2011 and 2012 will be taxed at the 0% and 15% rates. Collections in later years may be subject to higher capital gain rates and, for some upper income clients, the new 3.8% Medicare tax may apply starting in 2013.

Planning point. The AMT often makes effective long term capital gain rate higher than 15%. And, of course, state tax makes the rate higher than "advertised."

Planning point. Clients' closely held corporations have two more years to pay out dividends at the 15% rate.

§6045(g) - Form 1099B Basis Reporting Requirement Starts in 2011 (NPRM REG-101896-09)

§6045(g) provides that every broker that is required to file a return with the IRS under §6045(a) showing the gross proceeds from the sale of a covered security must include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to the security is long-term or short-term. Thus, a broker that is currently subject to gross proceeds reporting under §6045(a) with respect to the sale of a covered security is also subject to the reporting of adjusted basis of that security and whether any gain or loss with respect to that security is long-term or short-term under §6045(g).

Note. GAO estimates that as many as seven million taxpayers – more than one in three who sold securities – may have misreported capital gains and losses. And around half of them did so because they misreported their basis. So actually the government is just here to help with those pesky recordkeeping requirements.

What's a "covered security?" For purposes of reporting under §6045(g), §6045(g)(3)(A) provides that a covered security is any specified security acquired on or after the applicable date if the security: (1) was acquired through a transaction in the account in which the security was held; or (2) was transferred to that account from an account in which the security was a covered security, but only if the broker receiving custody of the security receives a statement under §6045A (described later in this preamble) with respect to the transfer.

When is basis reporting required? The applicable date of the reporting requirements under §6045(g) depends on the type of specified security that is sold. For stock in or of a corporation (other than stock in a regulated investment company (RIC) or stock acquired in connection with a dividend reinvestment plan (DRP), the applicable date is January 1, 2011. For stock in a RIC or stock acquired in connection with a DRP (for which additional rules apply), the applicable date is January 1, 2012. For any other specified security, the applicable date is January 1, 2013, or a later date determined by the Secretary(§6045(g)(3)C)). The reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2013, as provided in §6045(h)(3).

How is basis determined? A broker must report a customer's adjusted basis: 1) for any security (other than RIC stock or DRP stock) using the first-in, first-out (FIFO) basis determination method unless the customer notifies the broker of the specific stock to be sold or transferred by means of making an adequate identification of the stock sold or transferred at the time of sale or transfer; or, 2) for RIC stock or DRP stock in accordance with the broker's default method under §1012 unless the customer notifies the broker that the customer elects another permitted method (§6045(g)(2)(B)(i)).

How is RIC stock basis determined? Regulated investment company (RIC) stock acquired before January 1, 2012, is treated as held in a separate account from RIC stock acquired on or after that date. However, a RIC may elect, on a stockholder by stockholder basis, to treat all stock in the RIC held by the stockholder as one account without regard to when the stock was acquired (single account election). When this election applies, the average basis of a customer's stock is computed by averaging the basis of shares of identical stock acquired before, on, and after January 1, 2012, and all the shares are treated as covered securities (§1012(c)(2)). If a broker holds RIC stock as a nominee of the beneficial owner of the shares, the broker makes the election.

How is DRP stock basis determined? A dividend reinvestment plan (DRP) is any arrangement under which dividends on stock are reinvested in stock identical to the stock on which the dividends are paid. If stock is acquired on or after January 1, 2011, in connection with a DRP, the basis of that stock is determined under one of the basis computation methods permissible for RIC stock. Accordingly, the average basis method may be used for determining the basis of DRP stock. This special rule for DRP stock, however, applies only while the stock is held as part of the DRP. If the stock is transferred to another account each share of stock has a cost basis in that other account equal to its basis in the DRP immediately before the transfer (with adjustment for charges connected with the transfer) (§1012(d)).

How are wash sales reported? Unless the Secretary provides otherwise, a customer's adjusted basis in a covered security generally is determined for reporting purposes without taking into account the effect on basis of the wash sale rules of §1091 unless the purchase and sale transactions resulting in a wash sale occur in the same account and are in identical securities (rather than substantially identical securities as required by §1091) (§6045(g)(2)(B)).

How are short sales reported? In the case of a short sale, gross proceeds and basis reporting under §6045 generally is required for the year in which the short sale is closed (rather than, as under the present rule for gross proceeds reporting, the year in which the short sale is entered into).

How are options reported? If a covered security is acquired or disposed of pursuant to the exercise of an option that was granted or acquired in the same account as the covered security, the amount received with respect to the grant or paid with respect to the acquisition of such option must be treated for reporting purposes as an adjustment to gross proceeds or as an adjustment to basis, as the case may be. Gross proceeds and basis reporting are required when there is a lapse of, or a closing transaction with respect to, an option on a specified security or an exercise of a cash-settled option on a specified security. Basis reporting does not apply to any option granted or acquired before January 1, 2013 (§6045(h)).

How is basis calculated if the security is purchased by one broker and sold by another? The Act added §6045A, which provides that a broker and any other person specified in Treasury regulations (applicable person) that transfers a covered security to a broker must furnish to the broker receiving custody of the security (receiving broker) a written statement that allows the receiving broker to satisfy the basis reporting requirements of §6045(g). Unless the Secretary provides otherwise, the statement required by this rule must be furnished to the receiving broker not later than fifteen days after the transfer of the covered security.

Form 1099-B filing date changed to February 15. An amendment to §6045(b) extends the due date from January 31 to February 15 for furnishing certain information statements to customers, effective for statements required to be furnished after December 31, 2008. §6045(b) provides that the statements to which the new February 15 due date applies are statements required under §6045 and statements with respect to other reportable items that are furnished with these statements in a consolidated reporting statement (as defined in regulations under §6045).

SOCIAL SECURITY (FICA) PAYMENTS

FICA Wage Base Remains at $106,800 for 2011

The Federal Insurance Contributions Act (FICA) is actually made up of two components, an old-age, survivor, and disability insurance (OASDI) and Medicare hospital insurance (HI), with both the employee and employer being subject to a 6.2% rate for the OASDI portion and a 1.45% rate for the HI portion.

Example. The self-employment tax liability for 2011 for someone making $250,000 would be:
$106,800 × 12.4% + [($250,000 × 92.35%) × 2.90%] = $19,939

FICA and SE Tax Update Chart	2010	2011
Maximum FICA (OASDI) Wage Base	$106,800	**$106,800**
FICA Tax Rate (6.2% (4.2% in 2011) +1.45%)	7.65	**5.65**
SE Tax Rate	15.3	**13.3**
Maximum FICA Tax (to OASDI limit)	$8,170	**$6,034**
Maximum SE Tax (to OASDI Limit)	$16,340	**$14,204**
Maximum Medicare HI Wage Base	Unlimited	**Unlimited**
Medicare HI Rate	1.45%	**1.45%**
Earned Income Ceilings for Social Security Benefits < Full Retirement Age	$14,160	**$14,160**
Medicare B Premium	$110.50/mo $1,326 to $4,343/yr	**$115.40/mo $1,384 to $4,429/yr**

Social Security Administration Forecasts OASDI Wage Base for 2011

The 2012 social security OASDI wage base is expected to increase by $3,300 to $110,100. Other estimates include $113,100 for 2013, $117,600 for 2014 and $122,700 for 2015.

Medicare B Premium Surcharge in 2011

Included in the 2003 Medicare prescription drug bill was a little-noticed provision that added a premium surcharge to be paid in addition to the normal Part B premium. Starting in 2007, the premium for Medicare Part B increased substantially for high income individuals. About 2.3 million people pay the increased Medicare premium. First-year retirees are often hit with the increased premium because of wages in the year of retirement.

To determine if the Social Security recipient is required to pay the premium surcharge for 2011, a "modified adjusted gross income" for 2009 must be calculated as follows:

1. The Social Security recipient's 2009 adjusted gross income.
2. Plus any tax-exempt interest, EE bond interest used for educational purposes, and any excluded foreign earned income.

2011 Medicare B and D Premiums

Individual			Married		
If your 2009 AGI is	**2011 monthly Part B premium**	**2011 monthly Part D surcharge**	**If your 2009 AGI is**	**2011 monthly Part B premium**	**2011 monthly Part D surcharge**
Under $85,000	$115.40	$0.00	Under $170,000	$115.40	$0.00
$85,000-$107,000	$161.50	$12.00	$170,000 -$214,000	$161.50	$12.00
$107,000-$160,000	$230.70	$31.10	$214,000-$320,000	$230.70	$31.10
$160,000-$214,000	$299.90	$50.10	$320,000-$428,000	$299.90	$50.10
$214,000+	$369.10	$69.10	$428,000+	$369.10	$69.10

Because there was no COLA increase to social security benefits in 2010 or 2011, the basic Medicare B premium remained at $96.40 for most recipients. The premium increased to $115.40 for beneficiaries who pay a means tested surcharge and for those who apply for benefits in 2011.

Disputing the surcharge. The surcharge results in higher income taxpayers paying 80% of the government's Medicare premium cost. Social Security recipients will have an opportunity to dispute the surcharge determination and use income from a later year if their circumstances change due to a major event such as death of a spouse, divorce, retirement, or a significant cutback in hours worked.

Social Security Limits Ability to Repay Benefits to Secure Higher Payment at a Later Age (Social Security Publishes New Rule Revising Withdrawal Policy)

Financial planners have been advising clients to take Social Security benefits at age 66, and then if all is well at age 70, repay the benefits collected and qualify for a much higher monthly payment. That game has just ended.

The Social Security Administration published final rules, effective Dec. 8, 2010, that limit the time period for beneficiaries to withdraw an application for retirement benefits to within 12 months of the first month of entitlement and to one withdrawal per lifetime.

PATIENT PROTECTION & AFFORDABLE CARE ACT (PPACA)
ADDITIONAL MEDICARE TAX ON WAGES & UNEARNED INCOME

Additional Medicare Tax on Wages and Self-employment Income for High Income Taxpayers (New §1401 & §3101) - Beginning in 2013

Employee portion of HI tax increased by 0.9% to 2.35% on combined wages over $250,000 MFJ (over $200,000 for single) starting January 1, 2013. Starting on January 1, 2013 the employee, but not the employer, portion of the HI tax is increased by an additional tax of 0.9% on wages received in excess of the threshold amount.

Increase applies to taxpayer and spouse's total wages. However, unlike the general 1.45% HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. The 0.9% additional HI tax will be reconciled on the taxpayer's Form 1040.

Additional HI withholding tax applies to employee's wages in excess of $200,000 without regard to spouse's wages. In determining the employer's requirement to withhold and the employer's liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account and the employer must disregard the amount of wages received by the employee's spouse. Thus, the employer is only required to withhold on its employee's wages in excess of $200,000 for the year, even though the tax may apply to a portion of the employee's wages at or below $200,000 if the employee's spouse also has wages for the year, they are filing a joint return, and their total combined wages for the year exceed $250,000. In essence, the employee's HI tax amount increases to 2.35% even though the employer's matching contribution remains at 1.45%.

> **Comment.** Therefore, the total HI employee and employer contribution in excess of the threshold amount will increase to 3.8%, the same percentage imposed on net investment income.
>
> **Example.** If Bill has wages $250,000 and his wife, Sharon, has wages of $100,000, Sharon's employer is not required to withhold any portion of the additional tax, even though the combined wages of Bill and Sharon are over the $250,000. But, Bill's employer is obligated to withhold the additional 0.9% HI tax on $50,000 of his wages – the amount above the $200,000 threshold. When Bill and Sharon file their tax return, they will have an HI liability of:

```
  $350,000 total wages
- $250,000 threshold
  $100,000
x      .9%
      $900 total additional HI tax
-     $450 additional withholding
=     $450 additional HI tax due with return
```

Employer must withhold employee's additional HI tax. The employer is required to withhold the additional HI tax on wages and is liable for the tax if the employer fails to withhold the amount of the tax from wages or collect the tax from the employee if the employer fails to withhold.

Additional HI for self-employed individuals. An additional tax of 0.9% is imposed on every self-employed individual on self-employment income in excess of the threshold amount. As in the case of the additional HI tax on wages, the threshold amount for the additional SECA HI tax is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. No deduction is allowed under §164(f) for the additional SECA tax, and the deduction under §1402(a)(12) is determined without regard to the additional SECA tax rate.

3.8% Medicare Tax Imposed on Net Investment (Unearned) Income (New §1411) - Starting 2013

Starting in 2013, a 3.8% Medicare tax is imposed on the lesser of:

- an individual's ***net investment income*** for the tax year
- ***or modified AGI in excess of a floor:*** $250,000 for joint filers and surviving spouses, $125,000 for a married taxpayer filing separately and $200,000 in any other case (§1411(a)(1) & (b)).

    Practitioner Point. There is no 3.8% Medicare tax if the taxpayer's MAGI is equal to or less than the threshold amount. And, of course, there is no Medicare tax for those taxpayers with high salaries and *no* investment income.

    Example - AGI over threshold but AGI difference smaller than investment income. In 2014, Ron's MAGI increases to $220,000. His 3.8% Medicare tax is limited to $760 as the tax applies to the lesser of $25,000 (net investment income) or $20,000 ($220,000 MAGI minus $200,000 threshold for a single).

    Example - AGI over threshold but investment income smaller than AGI difference. In 2015, Ron's MAGI increases to $250,000. His $25,000 of unearned income is subject to a 3.8% Medicare tax of $950, as the tax applies to the lesser of $25,000 (net investment income) or $50,000 ($250,000 MAGI minus $200,000 threshold for a single).

    Practitioner point. In January 2013, the highest marginal rate is scheduled to increase from 35% to 39.6%. The Medicare tax increases the highest marginal rate to 43.4%. For those with substantial net investment income, tax rates will increase 8.4% in 2013.

Investment income is the sum of:

1. Gross income from
    - A interest,
    - B dividends,
    - C royalties,
    - D annuities, and
    - E rents (unless such income is derived in the ordinary course of any trade or business other than from (2) or (3) below);
2. Gross income from a §469 passive activity;

3. A trade or business of trading in financial instruments or commodities (as defined in §475(e)(2)); and
4. Net gain (to the extent included in computing taxable income) attributable to the disposition of property[2] other than property held in any trade or business not described in (2) or (3) above (§1411(c)(1) and (2)). The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.

Net investment income is the above-mentioned investment income less any allowable deductions properly allocable to such income or gain (§1411 (c)(1)(B)).

Net investment income does not include:

1. Active income in family partnerships and S corporations, which will become more popular in attempting to avoid the 3.8% unearned income Medicare contribution tax.
2. Any item taken into account in determining self-employment income if HI or Medicare tax is imposed (§1411(c)(6)),
3. Any distribution from qualified employee benefit plans or arrangements (§1411(c)(5)),
4. Interest on tax-exempt and tax-deferred vehicles such as
   - A municipal bonds,
   - B tax deferred non-qualified annuities,
   - C life insurance,
   - D veterans' benefits,
5. Excluded gain from the sale of a principal residence, and
6. Other such items which are otherwise excluded from gross income.

These investments will become more attractive when compared to the above-listed investment income vehicles.

Distributions from qualified employee benefit plans or arrangements. As the 3.8% Medicare tax does not apply to distributions from IRAs and other qualified retirement plans, it may be helpful to increase contributions to §401(k) qualified cash or deferred arrangement plans, §403(b) tax shelter annuity plans and §457 tax-exempt organization deferral plans.

> **Caution.** Even though income from a qualified retirement plan or an IRA distribution is not included in *net investment income*, it is included in modified AGI, thereby subjecting other investment income to this 3.8% additional tax. Why would Congress specifically exclude pension income in one place and implicitly include it through the back door?

> **Roth IRA planning tip.** On the other hand, a Roth IRA is excluded from both *net investment income* and *modified AGI*. What about converting the IRA to a Roth IRA in 2010? Prior conventional wisdom held that investors over 50 would not, in their lifetime, get back a decent return on investment on this conversion. Therefore, Roth conversions were considered an estate tax planning device and not an

[2] When an interest in a partnership or S corporation is disposed of, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account. That net gain or loss is calculated as if the all the applicable property were sold at fair market value immediately before the disposition of the interest (§1411(c)(4)).

income tax planning device. This conventional wisdom needs to be rethought in light of Roth IRAs' role in minimizing the additional 3.8% tax.

Example. Eddie and Louise have wages of $200,000, investment income of $50,000 and annual IRA distributions of $65,000. Even though distributions from qualified employee benefit plans are specifically excluded as investment income, these same distributions are taken into account in determining modified AGI. Beginning in 2013, the $65,000 IRA distribution will cause $50,000 of investment income to be subject to the 3.8% additional tax, resulting in an additional tax liability of $1,900. Eddie and Louise *may* be candidates for a Roth conversion as a Roth distribution is not included in either net investment income or modified AGI.

Modified AGI. When calculating the new 3.8% unearned income Medicare contribution tax, modified AGI means an individual's AGI for the tax year increased by otherwise excludable foreign earned income or foreign housing costs under §911 (as reduced by any deduction, exclusions, or credits properly allocable to or chargeable against such foreign earned income) [§1411(d)].

Ideas for Keeping MAGI below the Threshold

Modified AGI may be reduced below $250,000/$200,000/$125,000 threshold amount by using:

- Installment sales
- Deferred annuities
- Municipal bonds
- Pension contributions
- Deferred compensation
- Charitable remainder trusts
- Charitable lead trusts

Example. In 2013, Paul and Susie report $275,000 as wages and $90,000 as net investment income. Their modified AGI is $365,000. Paul and Susie will pay a 3.8% unearned income Medicare contribution tax on the lesser of their: (1) $90,000 of net investment income or (2) $115,000 of modified AGI, the amount in excess of the $250,000 threshold for MFJ taxpayers. Their unearned income Medicare contribution tax in 2013 will be $3,420 ($90,000 x 3.8%).

Example. In 2013, Howard, a single taxpayer, earns $5.2 million in net investment income from a stock and bond portfolio. Howard's modified AGI is also $5.2 million. Howard will pay a 3.8% unearned income Medicare contribution tax on the lesser of his: (1) $5.2 million net investment income or (2) $5 million of modified AGI, the amount in excess of the $200,000 threshold for single taxpayers. Howard's unearned income Medicare contribution tax in 2013 will be $190,000 ($5,000,000 x 3.8%).

Exclusions. The 3.8% unearned income Medicare contribution tax does not apply to (a) nonresident aliens (b) a charitable remainder trust exempt from tax under §664 or (c) a §170(c)(2)(B) trust whose unexpired interests are devoted to religious, charitable, scientific, literary, and/or educational purposes, and/or to foster national or international amateur sports competition (provided that no parts of its activities involve the provision of athletic facilities or equipment), and/or to the prevention of cruelty to children or animals (§1411(e)).

Estates and trusts. Estates and trusts also must pay the 3.8% unearned income Medicare contribution tax on the lesser of:

- their undistributed net investment income for the tax year, or
- any excess of:
  - their AGI over
  - the estates and trusts highest tax bracket dollar amount for the tax year[3] (§1411(a)(2)).

IDEAS TO REDUCE MEDICARE TAX ON INVESTMENT INCOME

Reduce Investment Income by Maximizing:

1. Tax-exempt and municipal bond income
2. Roth IRA distributions
3. Retirement plan distributions
4. Gains from sales of business property

Reduce Investment Income by Minimizing:

1. Passive activity income
2. Limited partnership income
3. Gains on the sale of passive property
4. Rental real estate income
5. Rental income from personal property
6. Income from businesses with no material participation
7. Undistributable taxable income in a trust

INCOME FROM SOURCES OUTSIDE US & THE FOREIGN INCOME EXCLUSION

$92,900 Foreign *Earned* Income and $14,864 Foreign Housing Cost Exclusion in 2011 (Notice 2011-8, Sec. 2; Notice 2010-27, Sec. 2; Rev. Proc. 2009-50, Sec. 3.28)

1. The foreign earned income exclusion, indexed for inflation, is $92,900 in 2011.
2. The foreign housing cost exclusion is $14,864 ($92,900 X 16%).
3. Income in excess of the foreign income exclusion is taxed at a higher tax bracket.

Housing exclusion is increased in some high cost areas. Due to the high cost of living in some cities, determined to be over $27,870 ($92,900 x 30%) in 2011, higher foreign housing exclusions are allowed. See Notice 2011-8, Determination of Housing Cost Amount Eligible for Exclusion or Deduction for 2011.

Taxpayers may, however, elect to apply the 2011 adjusted limitations to the 2010 tax year, in lieu of the adjusted limitations provided in Notice 2010-27, 2010-1 CB 531, if the 2011 limitations are higher. The IRS anticipates that future annual notices providing adjustments to housing expense limitations will make a similar election available for housing expenses incurred in the immediately preceding year.

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[3] The highest rate (35%) for trusts in 2010 starts at taxable income over $11,200. The 35% rates for individual starts at taxable income over $373,650! Leaving undistributed taxable income in a trust is not smart tax planning!

Foreign earned income does not include:

- Pay received as a military or civilian employee of the U.S. Government or any of its agencies;
- Pay for services conducted in international waters (not a foreign country);
- Pay in specific combat zones, as designated by an Executive Order from the President, that is excludable from income;
- Payments received after the end of the tax year following the year in which the services that earned the income were performed;
- The value of meals and lodging that are excluded from income because it was furnished for the convenience of the employer; or
- Pension or annuity payments, including Social Security benefits.

New Pub 4732, Federal Tax Information for U.S. Taxpayers Living Abroad (*IRS Publication 4732*)

IRS has released new Publication 4732, Federal Tax Information for U.S. Taxpayers Living Abroad. As part of its "Reaching Out to Americans Abroad, International Tax Gap Series," IRS is endeavoring to educate Americans abroad as to compliance issues and obligations in an effort to recoup an estimated $50 billion in lost tax revenue per year through offshore tax havens.

RECORDS AND REPORTS OF CURRENCY AND FOREIGN TRANSACTIONS §1028.670

Reporting Foreign Bank and Financial Accounts (FBAR) (TIGTA Ref Number 2010-30-125; FS-2010-11; Form TD F 90-22.1)

Under the Bank Secrecy Act, each United States citizens, residents, and domestic entities must file a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), by June 30 if:

- The person has a financial interest in, or signature authority (or other authority that is comparable to signature authority) over one or more accounts in a foreign country, and
- The aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.

Schedule B. Line 7a of the 2010 Form 1040 Schedule B requires a "yes" or "no" if the taxpayer has a signature authority over financial accounts in a foreign country of more than $10,000. This is in addition to the requirement to file a Form TD F 90-22.1.

Statistics. From Calendar Years 2004 to 2009, the number of FBARs filed with the Treasury Department has increased 145% from 217,699 to 534,043. Between Fiscal Years 2004 and 2009, FBAR-related examinations created a 96% increase (from 334 to 656) in FBAR civil examinations. In addition, Examination function FBAR penalty assessments grew from $4.2 million to $20.5 million, an increase of 388% over the same period, while FBAR penalty collections grew from $1.8 million to $9.8 million.

A United States citizen is not prohibited from owning foreign accounts, but civil and criminal penalties may apply for failures to properly file FBARs when required. The information reported on an FBAR may be used for governmental purposes, including law enforcement and tax compliance purposes.

Due in IRS's office June 30 & post-mark irrelevant. The annual due date for filing Form TD F 90-22.1 (FBAR), is June 30. The FBAR must be received by the IRS on or before June 30. Unlike tax returns, the FBAR is considered filed on the day it is received by the IRS. Postmarks are not considered evidence of timely filing.

Foreign Bank Account Reporting FAQs (FBAR FAQ)

IRS updated its FBAR FAQ (54 Q&A'S) Website posting. The FAQs are intended to provide assistance to clients who want to voluntarily report foreign bank account information. The IRS also provides information for taxpayers who paid tax on their foreign source income but failed to file the Form TD F 90-22.1.

> **Tax Season Note**. Preparers should ask their clients about foreign investment accounts (bank and securities). The Form TD F 90-22.1 is required if, as mentioned previously, the aggregate value of the financial accounts exceeds $10,000. The penalties are enormous for those who fail to report.

Assistance. Help in completing Form TD F 90-22.1 is available at (800) 800-2877, option 2. The form is available online or by telephone at (800) 829-3676. Questions regarding the FBAR may be emailed to the IRS at FBARquestions@irs.gov.

Final Rules Regarding FBAR: Foreign Financial Account Reporting (RIN 1506-AB08; §1010; TD News Release)

Treasury has issued final rules regarding foreign financial account reporting. These rules identify the persons required to file reports of foreign financial accounts. The rules further specify the types of accounts that are reportable, and provide filing relief in the form of exemptions for certain persons with signature or other authority over foreign financial accounts. Finally, the rules adopt provisions intended to prevent persons subject to the rule from avoiding their reporting requirement. These rules apply to reports required to be filed by June 30, 2011, with respect to foreign financial accounts maintained in calendar year 2010 and for reports required to be filed with respect to all subsequent calendar years.

Who must file? Each U.S. person having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country worth more than $10,000 must provide information on the Report of Foreign Bank and Financial Accounts, Form TD-F 90-22.1 (FBAR) to the IRS for each year the account exists. The FBAR must be filed on or before June 30 of each calendar year for accounts maintained during the previous calendar year. Records must be maintained for each person having a financial interest in or signature or other authority over such accounts for a period of five years. A special rule exists for persons with a financial interest in 25 or more accounts, or signature or other authority over 25 or more accounts.

A "U.S. person" is a citizen or resident of the U.S., or an entity (including, but not limited to, a corporation, partnership, trust or limited liability company) created, organized or formed under the laws of the United States, any state, the District of Columbia, the territories and insular possessions of the United States or the Indian tribes. This definition includes disregarded entities.

Reportable accounts. An account is not a foreign account under the FBAR if it is maintained with a financial institution located in the United States. For example, individuals may purchase securities of a foreign company through a securities broker located in the United States as part of their investment portfolio. The

mere fact that the account may contain holdings or assets of foreign entities does not render the account "foreign" for purposes of the FBAR. In this instance, the individual maintains the account with a financial institution in the United States

In addition, the U.S. customer would not have to file an FBAR with respect to assets held in the omnibus account and maintained by a global custodian. In this situation, the U. S. customer maintains an account with a financial institution located in the United States. However, if the specific custodial arrangement permits the United States person to directly access their foreign holdings maintained at the foreign institution, the United States person would have a foreign financial account.

Signature or other authority. "Signature or other authority" means the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained. Thus, the test for determining whether an individual has signature or other authority over an account is whether the foreign financial institution will act upon a direct communication from that individual regarding the disposition of assets in that account. The phrase "in conjunction with another" is intended to address situations in which a foreign financial institution requires a direct communication from more than one individual regarding the disposition of assets in the account. The signature authority definition only applies to individuals.

Recordkeeping. U.S. individuals employed in a foreign country who file an FBAR because of signature or other authority over their employers' foreign financial accounts are not expected to personally maintain records of these accounts. However, these modified reporting requirements are not available to U.S. individuals employed in the U.S. with signature or other authority over their employers' foreign financial accounts.

No electronic filing . . . yet. The FBAR form, currently available on both the FinCEN and IRS websites, allows users to complete the form electronically and print a PDF document that can be mailed to the address on the form. FinCEN is in the process of modernizing its IT system and has plans to include the ability to file FBARs electronically.

Transition. Individuals who properly deferred filing obligations pursuant to Notice 2010-23, may apply the final regulations in determining their FBAR filing requirements for reports due June 30, 2011, with respect to foreign financial accounts maintained in calendar years beginning before 2010.

New! Foreign Asset Disclosure for 2011 Returns

Foreign Asset Reporting Task System (F-ARTS) for those with assets exceeding $50,000. On March 18, 2010, the President signed the Hiring Incentives to Restore Employment (HIRE) Act containing a provision that will both complement and contrast with the FBAR filing requirement. Specifically, the HIRE Act added §6038D, ***requiring*** individual taxpayers with an aggregate balance of more than $50,000 in foreign financial ***assets*** to file a statement with his or her income tax return. Unlike the FBAR information, which originates under Title 31 of the U.S.C. and normally is not permitted to be verified against tax return or tax return information due to privacy and disclosure concerns, the new provision under §6038D will have none of these restrictions. This change will allow the IRS to use its full complement of tools to verify the information or lack of information filed.

Note. The legislative history of the foreign financial account reporting stresses that its broad, primary purpose is intended to be a resource to combat white-collar crime and not just the narrower objectives of the Internal Revenue Code.

What's required in the disclosure. The new law requires that the disclosure statement describe the maximum value of the assets during the taxable year. The disclosure statement should also provide the following information in the case of a:

1. ***Financial account*** - the name and address of the foreign financial institution in which such account is maintained and the number of such account.
2. ***Stock or security*** - the name and address of the foreign issuer and such information as is necessary to identify the class or issue of which such stock or security is part.
3. ***Contract, interest, or other instrument*** - such information as is necessary to identify such contract, interest, or other instrument and the names and addresses of all foreign issuers and counterparties with respect to such contract, interest, or other instrument.

FBAR and §6038D can have different reporting requirements. Differences exist between the FBAR requirements and §6038D. Individual taxpayers in similar circumstances could have different reporting outcomes.

Example. Two individual taxpayers owning foreign stocks worth $55,000 can end up with entirely different reporting outcomes. Sharon, who owns $55,000 in foreign stocks through a foreign stock brokerage account, is required to file both an FBAR and complete the §6038D disclosure on her tax return, while Vern, who holds $55,000 worth of foreign stocks issued by a person other than a U.S. person outside of a foreign financial account, is required only to complete the §6038D disclosure on his tax return. In this example, if the stock is worth $45,000, rather than $55,000, Sharon is only required to file an FBAR and Vern is not required to file a disclosure of any type.

Chart Comparing FBAR and §6038D Reporting Requirements		
Description	FBAR	IRC §6038D (F-ARTS)
Type of taxpayer	U.S. person (defined as individual, corporation, partnership, trust or estate, a joint stock company, or other unincorporated organization or group) means a citizen or resident of the U.S. or a person in and doing business in the U.S.	Individual, U.S. citizen or resident alien, or any domestic entity formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets.
Time period covered	Any time during the calendar year.	Taxable year
Filing form	TD F 90-22.1	To be announced
Information due date	To Treasury by June 30, no extensions	With tax return by April 15, including extensions
Type of interest in foreign financial	Financial interest in, or signature authority over, foreign financial	Any interest in foreign financial asset.

accounts/assets	accounts.	
Value making foreign account/asset reportable	Aggregate value of financial ***accounts*** exceeds $10,000.	Aggregate value of all such ***assets*** exceeds $50,000.
Type of foreign financial accounts/assets reportable	Bank account, securities account, or other financial account in a foreign country. Term also includes savings, demand, checking, deposit, time deposit, or other account (including debit card and prepaid credit card accounts) maintained with a financial institution or other person engaged in the business of a financial institution.	1. Any financial account maintained by a foreign financial institution. 2. Any of the following assets which are not held in an account maintained by a financial institution— A. Any stock or security issued by a person other than a U.S. person. B. Any financial instrument or contract held for investment that has an issuer or counterparty which is other than a U.S. person. C. Any interest in a foreign entity.

OTHER GROSS INCOME ITEMS

IRS Data Show a 10-Fold Increase in the Amount and Number of Cancelled Debts (GAO-10-997)

IRS estimates the amount of cancelled debt reported on Form 1099-C has increased over 10 times—from about $19 billion worth of debt in TY 2007 to about $216 billion worth of debt for TY 2009 (as reported to IRS through June 2010). The number of Form 1099-Cs has increased about 80% from about 2 million debts to about 3.6 million debts.

> **Tax preparer tip**. IRS expects to post on its website for the 2011 tax filing season an internal "tax assistant tool" used for computing cancelled debt.

Cancelled Credit Card Debt Creates COD Income (§61(a)(12)/§108)

Reduction of $16,000 of Credit Card Debt by MBNA Must Be Reported as COD income *Ancil N. Payne, Jr. & Mary E.K. Payne v. Comm.*, 2010-1 USTC ¶50, 132, (8th Cir.) 08-2386, aff'TCM 2008-66

Ancil Payne ran up $21,000 of credit card debt, primarily for medical expenses, and settled with MBNA for $4,600 because he was unemployed. MBNA sent him a Form 1099-C for $16,000. The court rejected Ancil's argument that COD doesn't include the discharge of interest expense.

- *Lawrence E. Hill v. Comm.,* TCM 2009-101, Credit card company's cancellation creates taxable COD income.
- *Paul Neal Jensen v. Comm.*, TCM 2010-77. COD income belongs to taxpayer even though ex-wife assumed the debt in the divorce and promised to indemnify in case of default.

Exclusion from Income (§108)

Cancellation of Debt (COD) is excludable from income if it occurs:

1. In bankruptcy
2. To an insolvent borrower, but only to the extent of insolvency
3. With qualified farm debt
4. With qualified real property business debt (for taxpayers other than C corporations (§108(a))
5. In discharge of qualified principal residence indebtedness between 1/1/2007 and 12/31/2012 (§108(a)(1)(E))
6. With seller financing (§108(e)(5))
7. When payment of the debt would result in a tax deduction to the borrower (§108(e)(2))
8. With certain student loans (§108(f); Rev. Rul. 2008-34)
9. As part of a bona fide dispute

When Is the Cancellation of Debt Created?

Is it when the lending institution sends the Form 1099-C? Or is it when the debt is written off by the lending institution? Numerous courts have clearly pointed out that the issuance of the Form 1099-C is irrelevant when trying to determine when the discharge of debt happened. The Form 1099-C is solely an information report. COD income can occur only, if at all, when the debt is discharged. When do we know when that has happened? According to IRS regulations, the identifiable events that indicate a debt has been cancelled are: bankruptcy, foreclosure (because the debt becomes unenforceable), when the statute of limitations make the debt unenforceable, then the debt goes through probate, by agreement between the parties (for example a short sale), but most importantly, when the creditor decides to discontinue collection activity and discharges the debt. This often is evidenced by writing the debt off the books, which can occur years before, or after, the issuance of the Form 1099-C!

COD Income Created In Year State Law Terminated Creditor's Right to Attempt to Collect, Not When Payments Stop (*Richard and Suzun Abbott v. Comm.*, TCS 2010-88)

Richard and Suzun Abbott quit making payments on a loan they had obtained from Commonwealth Central Credit Union (Commonwealth) in 2003. In 2007, four years after receiving the last payment, Commonwealth cancelled the debt of $4,753 and sent the Abbotts a 1099-C. The Abbotts did not include this amount on their 2007 tax return, claiming that the debt was cancelled in 2004, not 2007.

It was the policy of Commonwealth to cancel debt when no payment was received for a period of three years and the obligation was no longer collectible. This policy is consistent with California law, where Commonwealth was located. Commonwealth periodically attempted collection of the debt in 2004-2006, but cancelled the debt in 2007 when state law would no longer allow it to pursue collection action. The court agreed with the IRS that the debt was cancelled and COD was generated in 2007.

ADJUSTMENTS TO GROSS INCOME

FLEXIBLE SPENDING ARRANGEMENT AND HEALTH SAVINGS ACCOUNT UPDATE

COMPARISON CHART FSA and HSA		
	Flexible Spending Arrangement (FSA) §125	**Health Savings Account (HSA) §223**
Eligibility	Eligible employees whose employers offer this benefit	(1) Individuals with qualifying high deductible insurance on the first day of the month (2) not covered by any other health plan (3) not entitled to Medicare benefits (4) not claimed as a dependent on another's tax return.
Definition of qualifying insurance	No requirements	Deductible must be at least $1,200 for an individual plan and $2,400 for a family plan. Out of pocket expenses cannot exceed $5,950 for an individual plan or $11,900 for a family plan.
Contributions	Usually funded by employee salary deduction but employer can contribute	By any person for eligible individual
Annual contribution limits	None until 2013 when $2,500 maximum applies	$3,050 for self only and $6,150 for family coverage. Account owners 55 or older (and not under Medicare) can contribute an additional $1,000
Annual out-of-pocket limits	N/A	$5,950 for self only and $11,900 for family
Contributions date	Total annual allocation is divided by number of pay periods remaining in the plan year	Contributions can be made up to 4-15 of following year

Qualifying expense	Most unreimbursed medical expense as defined in §213(d) Not over-the-counter medicines beginning in 2011 May not be used for health insurance or LTC insurance.	Most unreimbursed medical expense as defined in §213(d) Not over-the-counter medicines beginning in 2011 May be used for LTC insurance, COBRA and health insurance for those collecting government unemployment benefits.
Reimbursements for immediate eligible expenses	Total plan year contributions are accessible on the first day of the plan year	Can be reimbursed only up to the current account balance and must resubmit remaining expense as HSA contributions accumulate
Claim substantiation	Claimants required to submit documentation that medical expense was incurred	None required but claimant must have receipts available for the IRS
Allowable non-medical withdrawals	None	Subject to income tax and 20% penalty except for disability, death or attaining age 65
Carryover of unused funds	Balances at year end (or up to 2 ½ months after year's end if employer permits) forfeited to employer. A limited one-time rollover to HSA is allowed	Full amount may be carried over indefinitely
Form 5500	Required but exception for small plans with less than 100 employees	Generally not required
Non discrimination rules	Prohibits discrimination in favor of highly compensated employees	If employer contributes, must make comparable contributions for all participants. 35% penalty applies.
Portability	Balances generally forfeited at termination	Portable
Subject to COBRA	Yes	No

Health Savings Accounts - How Much May Be Contributed to an HSA (Rev. Proc. 2010-22)

Two types of contributions may be made to HSAs, regular and catch-up. Both have annual limits.

	2011		2010	
	Family	**Self only**	**Family**	**Self only**
Contribution limit	$6,150	$3,050	$6,150	$3,050
Additional catch-up contribution for taxpayer age 55 or older	$1,000 per qualifying spouse	$1,000	$1,000 per qualifying spouse	$1,000
Minimum health insurance deductible	$2,400	$1,200	$2,400	$1,200
Maximum out-of-pocket	$11,900	$5,950	$11,900	$5,950

Catch-up contributions may be made by individuals who are at least 55 years of age but not yet enrolled in Medicare. For years beginning on or after January 1, 2009 an additional $1,000 may be contributed. Currently, there is no provision in the law to increase the catch-up contributions beyond the $1,000 amount and there is no inflation indexing.

> **Warning**. Catch up contributions may be made only to a person's own individual HSA account. Therefore, a person may not make catch-up contributions to a family HSA in his or her spouse's name (Notice 2008-59, Q. 22). For example, a wife cannot contribute a catch-up contribution to a family HSA in the husband's name. She would have to open her own separate HSA.

HSA and HRA Participation Continues to Grow (Executive summary, Employee Benefit Research Institute)

In 2010, there were 5.7 million HSA and HRA accounts, up from 5 million in 2009. The average account balance was $1,355, down from $1,419 in 2009.

Annual Contribution Limits Vary Based on Circumstances.

Married couples are limited to one maximum HSA family contribution amount ($6,150 in 2010) regardless of whether each spouse has a self only or family HSA. For example, if husband has a self only HSA and wife has a family HSA, the 2010 HSA contribution limit is a maximum of $6,150, split evenly between the spouses unless they agree to split the amount otherwise. The result is the same even if both spouses have family HSAs.

Health Care Reform Act Imposes $2,500 Annual Contribution Limit to FSA Beginning in 2013

After December 31, 2012, the maximum amount that an employee can set aside for pre tax medical in his flexible savings account (FSA) is $2,500. FSA contributions are limited by the employer not the IRS.

> **Factoid**. The average employee contribution to an FSA is $1,400.

Health Care Reform Act Limits Distributions from Health Accounts for Over-the-counter Medicines Beginning in 2011 (Notice 2010-59)

After Dec. 31, 2010, the cost of over-the-counter medicines may not be reimbursed with excludible income through a Health Flexible Savings Account (FSA), Health Reimbursement Account (HRA), Health Savings Account (HSA), or an Archer Medical Savings Account (MSA), unless the medicine is prescribed by a physician. Under §106(f), expenses incurred for medicines or drugs may be paid or reimbursed only if:

1. the medicine or drug requires a prescription;
2. is available without a prescription (over-the-counter medicine or drug) and the taxpayer obtains a prescription; or
3. is insulin.

> **Comment.** This reverses Rev. Rul. 2010-23 that permitted Health FSAs to reimburse certain over-the-counter drugs, such as Prilosec OTC. This change, along with the lowering of the maximum FSA limit, makes FSAs less attractive than other medical plans.

What Is the Tax Treatment of HSA Distributions?

Withdrawals from HSAs are exempt from federal income taxes if used for qualified medical expenses as defined under §213(d). Payments for health insurance are considered qualified expenses under §213(d), they generally are not qualified for purposes of HSA withdrawals. However, payments for four types of health insurance are qualified HSA medical expenses:

1. Premiums for long-term care insurance,
2. Health insurance premiums during periods of continuation coverage required by federal law (e.g., COBRA for account beneficiary or spouse),
3. Health insurance premiums during periods the individual (or spouse) is receiving unemployment compensation, and
4. For individuals age 65 years and older, any health insurance premiums (including Medicare Part B and D premiums) other than a Medicare supplemental policy.

> **Warning.** While individuals age 65 or older may use HSA distributions to pay for medical insurance premiums, this is only true for the HSA account owner/beneficiary, not for the spouse. For example, if the HSA account owner is not yet age 65, and the spouse is age 65 or older, HSA distributions may not be made to pay for the spouse's Medicare or other health insurance premiums (Notice 2008-59, Q. 30).

Heath Care Reform Act Increases Penalty on HSA and MSA Distributions Beginning in 2011

Withdrawals not used for qualified medical expenses are included in gross income in determining federal income taxes and are subject to a 10% penalty tax (2010). After December 31, 2010, the additional tax on distributions from an HSA that are not used for qualified medical expenses is increased from 10% to 20% of the disbursed amount. The penalty is waived in cases of disability or death and for individuals age 65 and older. There are no minimum required distributions from HSA, regardless of the account owner's age.

> **Note**. The penalty for an MSA is increased from 15% to 20%.

QUALIFIED STATE TUITION PROGRAMS §529

Wonderful Estate and Gift Tax Planning Device (IRS Fact Sheet on 529 Plans, FS-2009-12)

The estate and gift tax rules applying to educational IRAs also apply to contributions to qualified tuition programs. Contributions to a qualified tuition program will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the present law gift tax exclusion provided by §2503(b) and also are excludable for purposes of the generation skipping transfer tax (provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift tax exclusion limit of $13,000, or $26,000 in the case of a married couple).

> **Tax planning:** For more information, see www.savingforcollege.com

Special rule for contributions exceeding $13,000/$26,000 limit ($65,000/$130,000 for five-year gift). If a contribution in excess of $13,000 ($26,000 in the case of a married couple) is made in one year, the contributor may elect to have the contribution treated as if made ratably over five years beginning in the year the contribution is made.

Under this rule, a donor may contribute up to $65,000 every five years ($130,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made from the donor to the beneficiary in the five-year period. A gift tax return must be filed with respect to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor's gift tax return. If a donor making an over $13,000 contribution dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is includable in the donor's estate.

Losses in the §529 plan account. The §529 plan was enacted to allow a parent, grandparent, or other donor to open a college savings account for a beneficiary. Income from the account is currently deferred and becomes tax free if the funds are used for the beneficiary's college expenses. But §529 accounts have suffered the same losses as other stock accounts. The question is whether losses are deductible if the §529 account balance has dropped below the donor's contributions? While the IRS has not provided an answer to this question, you can find some guidance at www.savingforcollege.com. It seems that if the donor closes the §529 plan for the beneficiary, losses can be deducted, but they are Schedule A miscellaneous itemized deduction subject to 2% of AGI limitations and, of course, the AMT preference impact.

Coverdell Education Savings Accounts

Expanded Coverdell Accounts temporarily extended. Coverdell Education Savings Accounts are tax-exempt savings accounts used to pay the higher education expenses of a designated beneficiary. The EGTRRA increased the annual contribution amount from $500 to $2,000 and expanded the definition of education expenses to include elementary and secondary school expenses. The 2010 Tax Relief Act extends the changes to Coverdell accounts for an additional two years, through 2012.

> **Planning point**. Coverdell contributions may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 MFJ); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the

taxpayer. §529 plan contributions can be made regardless of the contributor's AGI or the age of the beneficiary. §529 plans have contribution limits far in excess of the $2,000 allowed for the Coverdell.

QUALIFIED HIGHER EDUCATION EXPENSE DEDUCTION

Tuition Deduction (§222; The Tax Reform Act of 2010)

Tuition deduction expires December 31, 2011. Through 2011, qualified taxpayers are allowed an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Taxpayers with AGI not exceeding $65,000 ($130,000 in the case of married taxpayers filing joint returns) are entitled to a maximum higher education ***tax deduction*** of $4,000 ***and*** taxpayers with AGI that don't exceed $80,000 ($160,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $2,000. Taxpayers with adjusted gross income above these thresholds are not entitled to this deduction. This deduction is not allowed if the American Opportunity Tax Credit produces a lower tax.

EDUCATOR DEDUCTION

$250 "Above-the-Line" Deduction For Classroom Materials Expires December 31, 2011 (§62(a)(2)(D); The Tax Reform Act of 2010)

Above-the-line deduction for certain expenses of elementary and secondary school teachers. The 2010 Tax Relief Act extends for two years (through 2011) the $250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and service), other equipment, and supplementary materials used by the educator in the classroom. All qualified deductions must be properly substantiated (***Peter I. Basalyk v. Comm*****., TCM 2009-100**).

ALIMONY/SEPARATE MAINTENANCE/DIVORCE

Introduction to Alimony Deduction/Income (§71 & §215)

Alimony and separate maintenance payments are deductible from income by the payor spouse under §215 if includable in income of the payee spouse under §71. Property settlement payments are deemed gifts (§1041) between spouses and never create income or deductions. But, if the following specific requirements are met, a payment received by, or on behalf of, the payee spouse (or former spouse) qualifies as an alimony or separate maintenance payment:

1. Payment in cash (transfer of property or services do not qualify).
2. Received by spouse (or on behalf of spouse – i.e., indirect alimony).
3. Received under divorce or written separation agreement (i.e., no voluntary payments).
4. Not alimony if agreement designates payments as excludable from payee spouse's gross income.
5. Payee and payor spouse cannot live together (no joint return).
6. Alimony must stop after payee spouse's death (state statutes may require if agreement silent!)
7. Recapture may be required if "excess front-loading" (i.e., if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000 and to the extent the payments in the second year exceed the payments in the third year by more than $15,000)

Payments related to taxpayer's income. The front-end loading rules do not apply if (1) the payor spouse agrees to pay a fixed portion of income from a business, property or compensation over a period not less than three years, and (2) either spouse dies or remarries before the end of the third year (§71(f)(5)).

Indirect alimony. Payments of cash to a third party under the terms of the divorce or separation instrument or made at the written request of the payee spouse will qualify as alimony (if the parties intend it to be treated as alimony). If the payee benefits economically by the payments, it is alimony (see TR §1.71-1T, Q 5&6). Examples of indirect alimony include cash payments of rent, mortgage, tax or tuition liabilities of the payee spouse made under terms of the divorce or separation agreement.

Child support. Payments are not alimony if the agreement fixes part of any payment for child's support (1) in dollar amounts, or (2) percentage. A payment is child support (not alimony) if the reduction occurs at a time "clearly associated with a contingency" (this is a presumption only). Examples of a clear contingency include: (a) reduction occurring six months before or after age 18, 21, or majority, (b) reduction occurring more than one year before or after two or more children reach the same age and (c) the child (1) attaining a specified age, (2) dying, (3) leaving school, (4) marrying, (5) leaving home, or (6) gaining employment (See Temp. Reg. §1.71-1T(c)). If under payments are made, the underpayment is deemed to go to child support first (§71(c)(3)).

- *Kelly A. Smith fka Kelly A. Waite v. Comm*, TCS 2010-15, court determined that the payments were alimony, and not child support, despite ambiguity being present in the divorce decree.

Payments to Ex-Spouse Nondeductible as Alimony Was Due to Contingency Related to Child (*Eric S. Knoedler v. Comm.*, TCS 2011-18)

Eric Knoedler married Mary in 1980, and they had two children: J.K., born in 1985, and S.K., born in 1987. In 2000 Mary filed for divorce and Eric and Mary entered into a postnuptial agreement which provided (in part):

> HUSBAND'S SUPPORT OF FAMILY: Husband agrees that Wife is the primary custodian for the children. Prior to the graduation of * * * [S.K.] from high school * * * Husband shall provide funds in the amount of $2,000.00 per month for Wife's use for her care of the children and her own personal expenses. * * * Should Wife either remarry or cohabitate with someone of the opposite sex for more than one month, then Wife agrees to deposit ½ of the monthly $2,000.00 family support payment into a separate bank account in trust for the children's college education.
>
> Following * * * [S.K.]'s graduation * * * the support amount shall be adjusted to $1,000.00 per month per child in college. Further Husband shall only be responsible for 4 years of college education per child; this obligation will terminate upon either child's decision to withdraw from one full year of college (i.e., withdrawal from two concurrent semesters of college).

The court determined that Eric could not deduct as alimony the amount of payments he made to Mary under this postnuptial agreement as the agreement contained a contingency related to a child. Reduction of payments after the child's graduation constituted a contingency related to a child and, therefore, the payments were nondeductible child support.

Eric argued that the State court's decision to allocate the family support payment equally as child support and spousal support was binding for Federal income tax purposes. The court disagreed, stating that it is well settled that the labels assigned to payments by the parties or a divorce court are not determinative for Federal income tax purposes. Moreover, State court adjudications retroactively redesignating payments as alimony and not child support (or vice versa) are generally disregarded for Federal income tax purposes (see *Gordon v. Comm.*, 70 T.C. 525, 530 (1978)). Thus, it is the express terms of the agreement which dictate the Federal income tax consequences of the payments which Eric Knoedler made to Mary and not the subsequent State court allocation.

Property Settlement vs. Alimony

Generally, no gain or loss is recognized on transfers of property between spouses or on transfers of property to a former spouse that are incident to a divorce (§1041(a); §1041(d)). This tax-free §1041 transfer is treated as a gift, meaning that neither spouse recognizes any income as a result of the transfer. The carryover basis rules applies. Alimony, on the other hand, creates both income and deductions. Determining if the transfer of property is property settlement or alimony can sometimes be difficult, as the following cases illustrate.

Installment Payments to Ex-Spouse Not Allowed as Alimony Deduction (*James David Shiley v. Comm. pro se*, TCS 2011-11)

The $6,000 annual payment made by James D. Shiley to his former spouse was not deductible as alimony. The separation agreement unambiguously provided that he shall pay his former spouse "As a further division of property" $65,000 under an installment arrangement. The agreement, in addition, stated that neither party shall be entitled to receive spousal support from the other. Even if the payments could have been considered spousal support, James would have still lost the deduction because the payments did not terminate upon the death of his former wife but, rather, the obligation was binding upon any heirs of either party.

Requirement #2: Mortgage Payments on Former Spouse's Residence Required by Divorce Decree Deductible as Alimony (*Ernesto Salcido & Victoria Lee Contreras, pro se. v. Comm.*, TCS 2010-35)

Ex-wife gets the house, ex-husband makes the house payments. In 2005, Ernesto and Norma Contreras divorce. The divorce decree granted their personal residence (on Casas Lindas) as Norma's sole property but with Ernesto paying, as "spousal maintenance, for the benefit of [Norma], the first mortgage, . . . together with real estate taxes and insurance on the property." In 2006, Ernesto deducted *as alimony* the full $5,746 of mortgage payments (principal, interest, taxes and insurance) he made on the Casas Lindas residence.

Ex-husband deducts 100% of the mortgage payments as alimony instead of half the interest and taxes as the IRS wanted. Ernesto argued that the divorce decree clearly delineated those payments as spousal maintenance. Therefore, Ernesto felt he was entitled to an alimony deduction for those payments (quoting the divorce decree) "as if it were received directly by * * * [Norma], and shall be reportable as income to her and as a deduction for * * * [Ernesto] for federal and state income tax purposes." The IRS argued that because Ernesto was still contractually liable on the mortgage note on the Casas Lindas residence, he received a benefit each time a mortgage payment was made and therefore was entitled to deduct only one-half of the deductible portion (interest and taxes) of the mortgage payments. They cited *Zinsmeister v. Comm.*, TCM 2000-364, in which the court stated:

> “When a divorce court orders one spouse to make payments on a mortgage ***for which both spouses are jointly liable,*** a portion of such payments discharges the legal obligation of the other spouse. In such circumstances the payee spouse has received income under the general principle of *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (payment by a third party of a person's legal obligation is taxable income to that person). Accordingly, in such cases, one-half of the mortgage payment is includable in the gross income of the payee spouse and, to the extent it otherwise qualifies as alimony, it is deductible by the payor spouse as alimony.”

It’s indirect alimony because there was no benefit to the ex-husband. In the area of housing, payments, which directly and more than incidentally benefit the wife and which do not directly and primarily benefit the husband, constitute alimony income to the wife (*Grutman v. Comm.*, 80 T.C. 464, 472 (1983)). The court emphasized that “the only benefit received by Ernesto was the reduction of his one-half of the monthly note owed to the lender. Therefore, the mortgage payments primarily benefitted Norma and constitute income to her in the form of alimony.” The court distinguish Ernesto from the *Zinsmeister* case, as he did not have any financial interest in Norma’s residence. The court held that the mortgage payments were indirect alimony.

Requirement #6: Husband’s Payment of Ex-wife Attorneys Fee Not Deductible, Even as Alimony (*Michael Raymond Glatfelter, Sr., pro se v. Comm.*, TCS 2010-20)

Because payment liability survived ex-wife’s death. Michael Raymond Glatfelter, Sr. claimed as an alimony deduction $3,400 arising from a court ordered payment by him for his former spouse’s attorney's fees. As the order was silent on Mike’s liability extending beyond the former spouse’s death, the issue was whether that liability would have terminated upon his former spouse's death by operation of California law. California case law provides that liability for attorney's fees derived from a post dissolution proceeding do survive a remarriage of the payee spouse. The Court of Appeals for the Ninth Circuit has decided that the remarriage and death provisions of Cal. Fam. Code §4337 should be interpreted “in a similar fashion.” Applying this reasoning, the Tax Court concluded that Mike's liability to pay his former spouse's attorney's fees would survive her death. Therefore these payments were not deductible as alimony.

- *Paul Thaddeus Banach, pro se v. Comm.,* TCS 2010-33, settlement agreement was silent on the issue of survivability of the obligation upon the ex’s death; Florida state law has held an award of lump-sum alimony survives the death of both the obligor and the obligee and therefore it is treated as a property settlement, not alimony.

STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

STANDARD DEDUCTION §63

Standard Deduction (Rev. Proc. 2011-12)	2010	**2011**
Married Filing Joint & Qualifying Widow(er)	$11,400	**$11,600**
Head of Household	$ 8,400	**$ 8,500**
Single	$ 5,700	**$ 5,800**
Married Filing Separate	$ 5,700	**$ 5,800**

Marriage Penalty Relief

Temporarily extends marriage penalty relief. The 2010 Tax Relief Act extends the marriage penalty relief for the standard deduction, the 15% bracket, and the EITC for an additional two years, through 2012.

> **Comment.** Nearly two out of three taxpayers take the standard deduction, rather than itemizing deductions, such as mortgage interest, charitable contributions and state and local taxes.

Additional Standard Deduction for Elderly and Blind

For a taxpayer (and spouse) who is age 65 or over or blind, the following applies:

1. **Unmarried Taxpayer.** For 2011, an additional $1,450 standard deduction amount is allowed, $2,900 for a taxpayer both elderly and blind in 2011.

2. **Married Taxpayer.** For 2011, an additional $1,150 standard deduction amount is allowed, $2,300 for a taxpayer both elderly and blind in 2011.

Standard deduction for dependents – If an individual *may* be claimed as a dependent on another's return (i.e., the exemption is "allowable" by another taxpayer), the dependent's basic standard deduction is limited to the *lesser* of (§63(c)(5)):

1. The basic $5,800 standard deduction for single taxpayers, *or*
2. The *greater* of $950 or the dependent's earned income plus $300.

> **Note**: This dependent must file his or her own return if unearned income exceeds $950 (for 2011) (unless the parents, by special election, report the income on their return); or the gross income exceeds the standard deduction.

ITEMIZED DEDUCTIONS

Itemized Deduction Limitation (§68(a)(2); (The Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312))

Temporarily repeals the itemized deduction limitation. Since 1991, the amount of itemized deductions that a taxpayer may claim has been reduced, to the extent the taxpayer's AGI is above a certain amount. This limitation is generally known as the "Pease limitation." The EGTRRA repealed the Pease limitation on itemized deductions for 2010. The 2010 Tax Relief Act extends the repeal of the Pease limitation for an additional two years, though 2012.

> **Planning point**. The extension of the "phaseout-of-the-phaseout" of exemptions and itemized deductions is projected to cost $20 billion. That means that our wealthy clients save $20 billion between 2011 and 2012.
>
> **Planning point.** Charitable organizations will benefit by the extension of taxpayer relief from losing itemized deductions. In 2010, some wealthy donors reduced their planned giving anticipating the loss or limitation of the charitable deduction. They now are more likely to continue with their planned giving activities for the next two years.

STANDARD MILEAGE RATES

2011 Standard Mileage Rate For Medical and Moving Increased Twice (Notice 2010-88, Rev. Proc. 2010-51, IR 2011-69)

Medical and moving standard mileage rate is 19¢/23.5¢ per mile. The IRS provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred of operating a passenger automobile. In addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate.

	2009	2010	**1/1/through 6/30/11**	**7/1 through 12/31/11**
Medical and moving	24¢	16.5¢	**19¢**	**23.5¢**
Charity[4]	14¢	14¢	**14¢**	**14¢**
Business	55¢	50¢	**51¢**	**55.5¢**

Charity mileage rates are fixed by statute.

MEDICAL, DENTAL, ETC., EXPENSES §213

Daughter Could Deduct Medical Expenses and Taxes Mother Paid on Her Behalf (*Judith F. Lang v. Comm.*, TCM 2010-286)

Mom paid and daughter deducted; IRS unhappy because amount exceeded $12,000 and no gift tax return filed. On Schedule A of her 2006 Federal tax return, Judith Lang claimed $35,355 in itemized deductions consisting of: (1) $27,776 in medical expenses, (2) $339 in State and local taxes, (3) $6,840 in real estate tax, and (4) $400 in gifts to charity. Somehow, the IRS found out that Judith's mom, Frances Field, paid $24,559 directly to the medical providers on account of Judith's medical expenses and paid $5,508 directly to the city government on account of Judith's real estate tax. Judith was not a minor, and Mrs. Field was not legally obligated to pay Judith's expenses. The IRS did not assert that Mrs. Field claimed the medical expense deduction for the amounts paid for her daughter, only that Mrs. Field paid the expenses and therefore Judith was not entitled to the deduction.

> **Comment.** I can't believe the IRS made the taxpayer go to court on this issue!

Daughter can deduct medical expenses, substance over form indicated donative intent. The court decided that state law controlled whether a gift at the time of payment affects who is the payor. It concluded that Mrs. Field made the medical expense payments for her daughter with donative intent. Although Mrs. Field and Judith would not be subject to the gift tax (even though it exceeded $12,000), the court pointed out that the income tax treatment is not controlled by the gift tax consequence (see *Pierre v. Comm.*, 133 T.C. 24, 35 (2009)). Applying substance over form, the court treated Judith as having received from her mother a gift of $24,559 with which Judith paid her own medical expenses.

Daughter can deduct real estate taxes - Tax Court had to explain the "indirect gift" regulations to IRS. The court's opinion sarcastically stated "To provide background we will explain the gift tax consequences. The regulations identify indirect gifts, such as payments made to a third party on behalf of a donee, as a 'transfer' to the donee" (see § 25.2511-1(a), (c)(1), (h)(2) and (3), Gift Tax Regs). Even though Mrs. Field paid $5,508 directly to the city government in discharge of Judith's obligation for real estate tax, the court again applied substance over form, and treated Judith as having received from her mother a gift of the $5,508 which Judith paid the city in satisfaction of her own real estate tax. Thus Judith was also entitled to a real estate tax deduction under §164 for that amount.

> **Comment.** This pro-taxpayer case flies in the face of the *Christina Marie Thompson McGrath v. Comm.*, TCM 2009-126 discussed next.

Wedding Gift of In Vitro Fertilization Not Deductible by Either Daughter or Papa (*Christina Marie Thompson McGrath v. Comm.*, TCM 2009-126)

In vitro fertilization is a deductible medical expense – if paid by the taxpayer. Christina Marie McGrath and her husband received $39,542 of in vitro fertilization services as a wedding gift from her father. The IRS did not dispute that the fact that in vitro fertilization services are indeed a deductible medical expense. But, the IRS successfully argued that Christina was not entitled to deduct the amount paid for medical expenses because her father had paid for the medical services on her behalf. There was no apparent error in the IRS's determination or analysis and Christina's position was unknown, because she failed to file a pretrial

memorandum or brief as ordered. The IRS had relied on a series of cases holding that taxpayers are not entitled to deduct medical expenses that they did not pay or that were reimbursed by some other source.

Comment. A dose of basic tax planning would have saved the medical expense deduction for Christina. Christina's father could have transferred cash to her with a subsequent payment of the medical expenses directly by Christina in order to salvage the medical expense deduction. This situation raises some interesting questions about how to salvage the income tax deduction while maximizing the gift tax exclusion for medical payments directly to a medical provider.

2011 Long Term Care Premium Limits

Annual long term care insurance premiums up to the dollar limitations below are treated as medical insurance expenses.

Age of Individual Before Close of Tax Year	**Maximum Deductible Premium**	**Maximum Deductible Premium**
	2010	**2011**
Not more than 40	$ 330	**$ 340**
More than 40 but not more than 50	620	**640**
More than 50 but not more than 60	1,220	**1,260**
More than 60 but not more than 70	3,290	**3,390**
More than 70	4,110	**4,240**

OTHER INDIVIDUAL ITEMS IN THE HEALTH CARE REFORM (PPACA)

Health Care Reform Act Increases AGI Haircut From 7.5% to 10% Starting in 2013

The threshold for the itemized deduction for unreimbursed medical expenses is to be increased from 7.5% of AGI to 10% of AGI for regular income tax purposes starting in 2013.

Except for those who are 65 or older in 2013-2016. If either the taxpayer or the taxpayer's spouse is 65 or older before the end of the taxable year, the AGI haircut remains at 7.5% of AGI and does not increase to 10% of AGI until 2017.

Preparer Point. Does this make sense? Insurance deductibles will go up (see FSA maximum) but deductions go down.

Note. The provision does not change the AMT treatment (i.e., the 10% haircut) of the itemized deduction for medical expenses.

Penalty for Failing to Carry Health Insurance (New §5000a) - Effective 2014

Most individuals are required to maintain minimum health insurance starting in 2014. Beginning in January 2014, non-exempt U.S. citizens and legal residents are required to maintain "minimum essential health coverage." It is anticipated that the individual mandate to purchase health insurance will add millions of new consumers to the health insurance market and achieve near-universal insurance coverage.

> ***The IRS will assess a "shared responsibility payment" (a.k.a. penalty) for individuals who do not have a minimum level of health insurance for themselves and their dependents.***

Minimum essential health coverage includes:

- ***Government sponsored health programs***, including Medicare, Medicaid, Children's Health Insurance Program, coverage for members of the U.S. military, veterans' health care, and health care for Peace Corps volunteers;
- ***Eligible employer-sponsored plans***, including group health plans or group health insurance coverage offered by an employer to the employee through the small or large group market[5] within a state, governmental plans, church plans, and grandfathered plans.
- ***Individual (i.e., non-group) market plans***;
- ***Grandfathered group health plans*** (i.e., a group health plan or coverage in effect on March 23, 2010); and
- Other coverage as recognized by the Secretary of Health and Human Services (HHS) in coordination with the Secretary of the Treasury.

Minimum essential coverage does not include: coverage that consists of certain Health Insurance Portability and Accountability Act (HIPAA) excepted benefits[6]. Other HIPAA excepted benefits that do not constitute minimum essential coverage if offered under a separate policy, certificate or contract of insurance include long term care, limited scope dental and vision benefits, coverage for a disease or specified illness, hospital indemnity or other fixed indemnity insurance or Medicare supplemental health insurance.

Exempt are prisoners, undocumented aliens, religious conscience and health care sharing ministry members. Individuals are exempt from the health coverage requirement for months they are incarcerated, not legally present in the United States or maintain religious exemptions. Those who are exempt from the requirement due to religious reasons must be members of a recognized religious sect exempting them from self employment taxes and adhere to tenets of the sect. Individuals residing outside of the United States are

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[5] The large group market consist of health plans maintained by large employers (generally those with more than 100 employees). The small group market consist of health plans maintained by small employers (generally those with no more than 100 employees; however, each state can elect to reduce this 100-employee threshold to 50 employees).

[6] HIPAA excepted benefits include: (1) coverage only for accident, or disability income insurance; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) workers' compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only insurance; (7) coverage for on-site medical clinics; and (8) other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

deemed to maintain minimum essential coverage. If an individual is a dependent of another taxpayer, the other taxpayer is liable for any penalty payment with respect to the individual.

Some applicable individuals are exempt from penalty. The following applicable individuals will be exempt from the penalty:

- ***Can't afford to pay for coverage because coverage exceeds 8% of household income.***
- ***Income below filing threshold.***
- ***Native Americans.***
- ***Short lapses of coverage (less than 3 months) during year.***
- ***Dependents.***
- ***Hardships.***
- ***Individuals outside of U.S.***
-

After 2013, a penalty tax applies to individuals who are not carrying health insurance. As mentioned previously, a penalty is imposed on applicable individuals who do not carry minimum essential health coverage for one or more months during a calendar year beginning in 2014. This penalty is paid with the taxpayer's income tax return.

Amount of penalty. The penalty is equal to ***the lesser of***:

1. The amount of the national average premium for qualified health plans that:
   A offer a bronze-level of coverage through an Exchange;
   B provide coverage for the taxpayer's family size; and
   C are offered through Exchanges for plan years beginning in the calendar year with or within which the tax year ends (§5000A(c)(1))[7] OR
2. The ***sum of the monthly penalty amounts*** for the tax year.

The amount of the monthly penalty is the greater of : (1) a flat fee per household or (2) a percent of income. Individuals who fail to maintain minimum essential health coverage for any month[8] in 2016 are subject to a penalty equal to ***the greater of***:

1. A flat dollar amount, or
2. A percentage of the taxpayer's household income (§5000A(c)(2)).

1. A flat dollar amount per household. The flat dollar amount equals ***the lesser of:***

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[7] This amount will be released by HHS annually. The amount is unknown at this time.

[8] §5000A(c)(2), titled "Monthly Penalty Amounts" confusingly states: "...the monthly penalty amount with respect to any taxpayer for any month during which any failure .... occurred is an amount equal to 1/12 of the greater of the following amounts: (A) Flat Dollar Amount. — An amount equal to the lesser of — (i) the sum of the applicable dollar amounts (i.e., $695 in 2016) for all individuals with respect to whom such failure occurred *during such month*, or (B) 300 percent of the applicable dollar amount (i.e., $695 in 2016) ..." Is it really Congress's intent that the taxpayer should take the $695 Flat Dollar Amount and again divide it by 12?

- The sum of $695 times each uninsured adult in the household who is required to be insured during that month (the fee for an uninsured individual under age 18 is one-half of the adult feet) divided by 12, or
- $2,085 (300% of the $695) divided by 12.

The per adult penalty is phased in as follows:

- $95 for 2014
- $325 for 2015
- $695 in 2016

For years after 2016, the $695 amount is indexed for inflation to CPI-U, rounded to the next lowest $50. Household income is the sum of the modified AGI of the taxpayer and all individuals accounted for in the family size[9] required to file a tax return for that year.[10]

2. Or a percentage of household income. This amount equals 2.5% of the excess of the taxpayer's household income[11] for the taxable year over the threshold amount of income required for income tax return filing for that taxpayer[12] divided by 12. Remember, this penalty doesn't apply for any month if the individual's household income for the year is less than the amount of gross income requiring the filing of a return.

The percentage of income is phased in as follows:

- 1% for 2014
- 2% in 2015
- 2.5% beginning after 2015

Marrieds are jointly liable. If a taxpayer files a joint return, the individual and spouse are jointly liable for any penalty payment.

IRS administers the penalty but can't get nasty about it. The penalty is assessed by the IRS and accounted for as an additional amount of Federal tax owed. However, the IRS's enforcement provisions are limited in two ways:

Criminal proceedings are limited. Non-compliance with the personal responsibility requirement to have health coverage is not subject to criminal or civil penalties.

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[9] Family size is the number of individuals for whom the taxpayer is allowed a personal exemption.

[10] Modified adjusted gross income means adjusted gross income increased by all tax-exempt interest and foreign earned income.

[11] Household income is the sum of the modified AGI of the taxpayer, spouse and all other individuals who are taken into account in determining the taxpayer's family size and are required to file an annual income tax return. This includes children subject to the "kiddie tax" whose unearned income is not reported on the parent's return.

[12] Generally, in 2010, the filing threshold is $9,350 for a single person or a married person filing separately and is $18,700 for married filing jointly (§6012(a)(1); IR-2009-93, Oct. 15, 2009).

Collection proceedings are limited. The use of liens and seizures otherwise authorized for collection of taxes does not apply to the collection of this penalty.

Interest on penalty has been eliminated. Interest does not accrue for failure to pay such assessments in a timely manner.

> **Comment.** IRS Deputy Commissioner for Services and Enforcement Steven T. Miller testified before the Senate Finance Committee in 2010 that the IRS will offset taxpayer refunds where they do not pay the penalty for inadequate health insurance coverage.

Health Insurance Premium Assistance Refundable Credit (New §36B) - Effective 2014

Premium assistance credit to help subsidize the purchase of health insurance. A refundable tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance through an Exchange has been created. The premium assistance credit, which is refundable, subsidizes the purchase of certain health insurance plans through an Exchange.

Premium credit available if coverage is unaffordable. If an employee is offered unaffordable coverage by his or her employer or the plan's share of provided benefits is less than 60%, the employee can be eligible for the premium tax credit, but only if the employee declines to enroll in the coverage and satisfies the conditions for receiving a tax credit through an Exchange. Unaffordable is defined as coverage with a premium required to be paid by the employee that is 9.5% or more of the employee's household income, based on the type of coverage applicable (e.g., individual or family coverage). The percentage of income that is considered unaffordable is indexed in the same manner as the percentage of income is indexed for purposes of determining eligibility for the credit (as discussed previously).

Employer must annually report employees who receive premium credit to IRS. The Secretary of the Treasury is informed of the name and employer identification number of every employer that has one or more employees receiving a premium tax credit.

No premium assistance credit available if employee can get coverage elsewhere. Generally, if an employee is offered minimum essential coverage in the group market, including employer-provided health insurance coverage, the individual is ineligible for the premium assistance credit for health insurance purchased through an Exchange.

Eligibility for premium credit. An individual must satisfy the following criteria to be eligible for the premium assistance credit:

1. ***Household income must be 100%-400% of federal poverty level.*** The taxpayer's household income must be at least 100%, but not more than 400%, of the federal poverty level (FPL) for the size of the family[13] involved.
2. ***Must be a qualified individual.*** At the time of enrollment, an individual must be a U.S. citizen or national or an alien lawfully in the United States and not be incarcerated (§36B(e)(2)).
3. ***Enrolled in a qualified health plan.*** The individual must be enrolled in a qualified health plan which is a health plan certified as eligible to be offered by an Exchange.

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[13] Family size is the number of individuals for whom the taxpayer is allowed a personal exemption.

4. ***Married taxpayers must file MFJ.*** To be eligible for the premium assistance credit, taxpayers who are married must file a joint return.
5. ***Dependents are ineligible for the credit.*** Individuals who are listed as dependants on a return are ineligible for the premium assistance credit.

Individual must pay amount above credit. The individual pays to the plan in which he or she is enrolled the dollar difference between the premium tax credit amount and the total premium charged for the plan[14]. Individuals who fail to pay all or part of the remaining premium amount are given a mandatory three-month grace period prior to an involuntary termination of their participation in the plan.

Employed individual pays through payroll deductions. For employed individuals who purchase health insurance through an Exchange, the premium payments are made through payroll deductions.

Too much advance payment of credit may end up as a tax due for the insured. The premium assistance credit must be reduced, but not below zero, by the amount of any advance payment of the credit paid directly to the insurer (§36B(f)(1)). If the advance payments for a tax year exceed the premium assistance credit allowed, the excess is an increase to the tax imposed for the tax year (§36B(f)(2)(A). But, if a taxpayer's household income is less than 400% of the family size FPL, this tax increase is limited to $400 ($250 for unmarried taxpayers) [§36B(f)(2)(B)(i)].

Eligibility based on income two years back. Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period.

Appeal for redetermination possible. Individuals (or couples) who experience a change in marital status or other household circumstance, experience a decrease in income of more than 20%, or receive unemployment insurance, may update eligibility information or request a redetermination of their tax credit eligibility.

Federal Poverty Level (FPL) establishes the subsidy. The "premium assistance credit" is available for individuals (single or joint filers) with ***household incomes*** between 100% and 400% of the Federal poverty level ("FPL") for the family size[15] involved who do not receive health insurance through an employer or a spouse's employer.

Health Insurance Exchanges Are Required to Be Established in Each State - Effective in 2014

To allow individuals to buy health insurance through the individual market because they don't have the option to purchase health insurance from their employer, or can't because of pre-existing conditions or other barriers, states must, by January 1, 2014, establish American Health Benefit Exchanges and Small Business Health Options Program (SHOP) Exchanges (referred collectively to as Exchanges) to be administered by a governmental agency or nonprofit organization. These exchanges are similar to the Massachusetts Connector under the Massachusetts health care reform program. Under these Exchanges, individuals and small businesses with 100 or fewer employees can purchase qualified coverage from a choice of certified health

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[14] Although the credit is generally payable in advance directly to the insurer, individuals may elect to purchase health insurance out-of-pocket and apply to the IRS for the credit at the end of the taxable year. The amount of the reduction in premium is required to be included with each bill sent to the individual.

[15] Family size is the number of individuals for whom the taxpayer is allowed a personal exemption.

plans rated by the Exchange. In 2017, all businesses, even those with more than 100 employees, may be permitted to purchase coverage. States may form regional Exchanges or allow more than one Exchange to operate in a state as long as each Exchange serves a distinct geographic area. At least two multi-state qualified health plans must be available in each state. The multi-state plans will provide coverage in the individual and small employer markets. The Director of the Office of Personnel Management will enter into contracts with private insurers to offer the multi-state plans.

Individuals Can Keep Their Old Health Plans - Effective in 2010

Individuals may keep their individual and group health plans that were in effect on March 23, 2010. In addition, these plans are exempt from many of the individual and group market reforms that take effect in 2014.

TAXES §164

Deduction of State and Local General Sales Taxes Expires December 31, 2011 (Emergency Economic Stabilization Act of 2008)

Claiming sales tax instead of income tax deduction. The 2010 Tax Relief Act extended for two years (through 2011) the election to take an itemized deduction for State and local general sales taxes in lieu of the itemized deduction permitted for State and local income taxes. Taxpayers are able to deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use optional sales tax tables created by the IRS (see Pub. 600). Taxpayers also may add to the table amount any sales taxes paid on: a motor vehicle, but only up to the amount of tax paid at the general sales tax rate; and an aircraft, boat, home (including mobile or prefabricated), or home building materials, if the tax rate is the same as the general sales tax rate.

No Sales Tax Deduction For New Home Purchase (*Jason and Misty Dewey v. Comm.*, TCS 2010-38

Jason and Misty Dewey purchased a new Mesa, AZ home from KB Home Sales (KB Homes) for $231,000. Arizona law does not provide for sales tax to be charged for the purchase of real property and the closing documents did not reflect any separately stated sales tax paid. However, Arizona does charge a 7.8% "transaction privilege" tax for real estate retail sales or prime contracting. While the Deweys did not pay this amount directly, they reasoned that it was part of the purchase price of their home and that the transaction privilege tax was the equivalent of sales tax. Under the direction of their tax return preparer, the Deweys deducted $8,929 of transaction privilege tax as sales tax on their 2005 tax return.

Sales tax definition very specific. The term "sales tax" is defined as a tax imposed upon persons engaged in selling tangible personal property, or upon the consumers of such property, which is a stated sum per unit of property sold or which is measured by the gross sales price or the gross receipts from the sale (§1.164-3(e)(1)). In addition, sales tax must meet two tests: (1) it must be a tax in respect of sales at retail, and (2) it must be general–-that is, it must be imposed at one rate in respect of the retail sales of a broad range of classes of items (§1.164-3(f)).

Sale of real estate not a retail sale, no deduction allowed. The IRS argued, and the Court agreed, that the transaction privilege tax was imposed on the sale of real property, not tangible personal property. Therefore, the sale of the new home by KB Homes to the Deweys was not a sale of tangible personal property and, consequently, was not a retail sale within the meaning of §164(b)(5)(B). No sales tax deduction was allowed.

- *Carl D. And Carol Naso v. Comm.*, TCS 2010-39, no sales tax deduction for new home purchase.

INTEREST §163

Home Mortgage Interest (§163(h)(3))

> **Comment.** According to the General Accounting Office, the IRS has directed its attention, and audit resources, toward the home mortgage interest deduction. Specifically, they are trying to determine if the taxpayer is violating the $1 million limit. In addition, they are matching the Form 1098 reported amount of mortgage interest payment to the taxpayer's Schedule A.

The exception to the interest tracing rules is any interest paid on a loan secured by a qualified residence. When ***qualified indebtedness*** is secured by a ***qualified residence***, this personal interest may be deductible as home mortgage interest if the following three conditions are met:

1. The taxpayer must file Form 1040 and itemize deductions on Schedule A;
2. The taxpayer must be legally liable for the loan (i.e., payments are not deductible if they are made for someone else or if the taxpayer is not legally required to make them; both the taxpayer and the lender must intend that the loan be repaid and there must be a true debtor-creditor relationship); and,
3. The mortgage debt must be secured by a qualified home.

What exactly is a qualified residence? To take a home mortgage interest deduction, the debt must be secured by a "qualified residence." This means either a principal residence (as defined under §121) and one other residence of the taxpayer that is selected by the taxpayer for purposes of §163(h) and that is used by the taxpayer as a residence (§163(h)(4)(A)(i)). A residence may include a house, condominium, cooperative, mobile home, house trailer, boat, or similar property; a second residence must contain sleeping, cooking, and toilet facilities (§1.163-10T(p)).

> **Note.** Interest paid on a mortgage for a home other than a taxpayer's main or second residence may still be deductible if the proceeds of the loan were used for a deductible purpose other than home mortgage interest (e.g., business, investment, rental activities, etc.). Otherwise, the interest paid is considered personal interest and is not deductible.

> **Caution!** For purposes of AMT, a "qualified residence" includes only a house, apartment, condominium, or mobile home not used on a transient basis (§56(a)(2)).

Interest paid on the main residence or second home is deductible. A taxpayer can have only one main residence at any one time and it will ordinarily be where he or she lives the majority of the time (§1.163-10T(p)(2)). A second home is a home that the taxpayer chooses to treat as his or her second home. A taxpayer cannot have more than one second residence at a time (§1.163-10T(p)(3)).

What are the Requirements for Qualified Indebtedness?

In order to satisfy the "qualified indebtedness" requirements of §163(h), the:

1. Taxpayer must be legally obligated on the debt;
2. Taxpayer must make the payments;

3. Debt must be properly collateralized; and
4. Total amount of the debt must be within the maximum amount limitations.

The collateral must be correct. Residence mortgage interest is deductible only if the mortgage is properly secured and collateralized. A secured debt is one in which there exists a signed instrument (such as a mortgage, deed of trust, or land contract) that:

1. Makes the taxpayer's ownership in a qualified home security for payment of the debt;
2. Provides, in case of default, that the home could satisfy the debt; and
3. Is recorded or is otherwise perfected under any state or local law that applies (§1.163-10T(o)(1)).

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

- *Natarajan Palaniappan and S. Dandamudi v. Comm.,* TCS 2010-82, homeowner borrowed money from a resident in India to purchase a residence in the United States, but no security interest was filed in the United States. Mortgage interest deduction was not allowed.

Election Available to Treat the Debt as Not Secured by Home

Why do this? Consider treating a debt as not secured by the taxpayer's home if the interest on that debt is fully deductible (for example, as a business expense) whether or not it qualifies as home mortgage interest. This may allow, if other home mortgage limits apply, more of a deduction for interest on other debts that are deductible only as home mortgage interest (§1.163-10T(o)(5)).

The "10-T" Election to Treat Debt as Not Secured by the Taxpayer's Qualified Home Should Be Made in Writing

Sample Election Statement Under Reg. Sec. 1.163-10T(o)(5)

Taxpayer Name: Joe Client
Social Security Number: 999-99-9999
Form: 1040
Tax Year Ending: 12/31/11

The taxpayer elects to treat $95,000 of home equity debt, the proceeds of which were used to purchase equipment and supplies for his business, as trade or business debt.

The interest on this debt for the tax year was $6,175 and is reported on Line 16b of Schedule C.

When is election due? A taxpayer may choose to treat any debt secured by a qualified home as not secured by the home. This treatment begins with the tax year for which the choice is made and continues for all later tax years. The election may be revoked only with the consent of the IRS.

What if the taxpayer failed to attach the election in writing (*Michael D. And Christine R. Alexander v. Comm.*, TCS 2006-127)? Mike and Chris Alexander incurred credit card debt to purchase equipment for their tree farm. The credit card debt was allocable to a trade or business expenditure (§1.163-8T(b)(7) and (c)(1)). Subsequently, the Alexanders took out a home equity loan, secured by their main home, and used the proceeds to pay off the credit card debt.

The temporary regulations provide that to the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a previously existing debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated (§1.163-8T(e)(1)). Mike credibly testified that he used the proceeds from the home equity loan to repay the credit card debt. The home equity loan was ruled by the tax court to be "replacement debt" and the interest accruing thereon was properly allocable to a trade or business expenditure even though the Alexanders did not attach a written election to their returns.

1.163-10T election may be made late, but guess who has to take the blame (LTR 200932030)? Late elections are allowed if taxpayers are able to establish that they acted reasonably and in good faith, which generally means that they relied on a qualified tax professional and the tax professional failed to make the election. In such cases, the IRS has allowed taxpayers to make the §1.163-10T(o)(5) election late.

Loan security does not dictate deductions. The allocation of loan proceeds and the related interest is not generally affected by what property is used to secure the loan (§1.163-8T(c)).

> **Example.** Cindy secures a loan with equipment used in her business. She uses the loan proceeds to buy golf clubs and a membership to the local golf club. Cindy must allocate interest expense on the loan to personal use (purchase of golf clubs and membership) even though the loan is secured by business property.

Qualified Residence Debt Limitations (§163(h)(3)(B))

In most cases, all home mortgage interest is deductible. However, whether it is all deductible depends on the date the taxpayer took out the mortgage, the amount of the mortgage, and the use of its proceeds (§163(h)(3)).

If all mortgages fit into one or more of the following three categories at all times during the year, deduct all of the interest on those mortgages. If any one mortgage fits into more than one category, add the debt that fits in each category to any other debt in the same category. If one or more mortgages does not fit into any of these categories, use the tracing rules to figure the amount of interest that is deductible.

There are three categories of mortgages that will qualify. They are:

1. Mortgages taken out on or before October 13, 1987 (called ***grandfathered debt***);
2. Mortgages taken out after October 13, 1987, to buy, build, or improve the taxpayer's home (called ***home acquisition debt***), but only if throughout the calendar year these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately);
3. Mortgages taken out after October 13, 1987, other than to buy, build, or improve the taxpayer's home (called ***home equity debt***), but only if throughout the calendar year these mortgages totaled $100,000 or less ($50,000 or less if married filing separately) ***and*** totaled no more than the fair market value of the home reduced by (1) and (2).

Comment. When a home is under water, that means the home equity debt is not deductible.

The dollar limits for the second and third categories apply to the combined mortgages on a taxpayer's main home and second home.

Home Equity Debt Limit

There is a limit on the amount of debt that can be treated as home equity debt. The total home equity debt on a main residence and second residence is limited to the ***smaller*** of:

1. $100,000 ($50,000 if married filing separately); or
2. The total of each home's ***fair market value (FMV***) reduced (but not below zero) by the amount of its home acquisition debt and grandfathered debt. Determine the FMV and the outstanding home acquisition and grandfathered debt for each home on the date that the last debt was secured by the home.

   Note: The fair market value limitation only impacts the deductibility of home equity indebtedness interest. There is no such restriction on acquisition indebted.

   Caution! For purposes of AMT, only home mortgage interest used to buy, build or substantially improve the taxpayer's principal residence or second home is deductible (§56(e)).

Is Acquisition Debt Allocated Per Person or Per Property?

IRS says $1 million limit applies per property, not per taxpayer (PLR 200911007). Although the IRS ruling never addresses whether the mortgage is actually acquisition indebtedness, it does state that under §163(h)(3)(B)(i), acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer – not as indebtedness incurred in acquiring taxpayer's portion of a qualified residence.

The entire amount of indebtedness incurred in acquiring the qualified residence constituted "acquisition indebtedness" under §163(h)(3)(A)(i). In this case, the amount of indebtedness incurred in acquiring the property exceeded $1,000,000. However, under §163(h)(3)(B)(ii), the amount treated as acquisition indebtedness for purposes of the qualified residence interest deduction was limited to $1,000,000 of total, "aggregate" acquisition indebtedness. The IRS believes this was evident from the parenthetical in §163(h)(3)(B)(ii) which limits the aggregate treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.

CHARITABLE CONTRIBUTIONS §170

Charitable Distributions from IRAs Expire on December 31, 2011 (The Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312); Qualified Charitable Distributions for 2010 and 2011)

An IRA owner, age 70½ or over, can directly transfer tax-free, up to $100,000 per year to an eligible charitable organization. This provides an exclusion from gross income for otherwise taxable IRA distributions

from a traditional or a Roth IRA in the case of qualified charitable distributions. Eligible IRA owners can take advantage of this provision, regardless of whether they itemize their deductions.

Some SIMPLE IRA or SEP IRA transfers to a charity may also qualify. Generally transfers can be made from any IRA to a charity. However a restriction applies to transfers from SIMPLE IRAs or SEP IRAs. If the employer has made a contribution to the plan during the year, it does not qualify for the charity transfer. If the employee (account owner) is retired and contributions are no longer being made to the SIMPLE IRA or SEP IRA, then the account qualifies for the §408(d)(8)(A) rollover.

Trustee to charity transfer required. To qualify, the funds must be contributed directly by the IRA trustee to the eligible charity. Amounts so transferred are not taxable and no deduction is available for the amount given to the charity.

Transfers are part of RMD. Transferred amounts are counted in determining whether the owner has met the IRA's required minimum distribution rules. Where individuals have made nondeductible contributions to their traditional IRAs, a special rule treats transferred amounts as coming first from taxable funds, instead of proportionately from taxable and nontaxable funds, as would be the case with regular distributions.

Planning points: Who benefits from an IRA transfer to a charity?

1. Non itemizers get the full benefit for the contribution ***and*** the standard deduction!
2. Since the IRA distribution made to a charity is not included in the client's taxable income, the many AGI related phaseouts are minimized. For example, the client does not experience:
   - A a 50% charitable contribution base limitation, or
   - B an increase in the amount of Social Security benefits taxable as he or she would under prior law if the IRA distribution is included in AGI and then the amount paid over to the charity is deducted on his or her schedule A.
3. Clients will have to rethink the source of large charitable contributions during their lifetime. Perhaps the gift from an IRA will be a better choice than the gift of appreciated stock. Since the IRA
4. produces income in respect of a decedent at the death of the account owner, leaving stock rather than the IRA may result in less tax to the beneficiary.
5. Since the IRA distribution made to a charity is not included in the client's AGI, the Medicare B and D premium surcharge may be reduced if an IRA transfer is made directly to the charity.

Planning Points. Non itemizers get the full benefit for the contribution ***and*** the full benefit of the standard deduction. The itemized deduction AGI phaseout is minimized, including both the 1% haircut and the 30%/50% charitable contribution base limitation. Maybe the income decreases for the 50%/85% Social Security income inclusion amount. And maybe the lower income reduces the Medicare Part B premium. Lastly, it permanently eliminates future income with respect to a decedent and maximizes on-hand cash that would normally be given to the charity.

Required Documentation for Charitable Deductions Chart

	Amount	Required records
CASH	Single cash contribution of less than $250	Cancelled check, bank record, credit card statement or written acknowledgment from the charity. §170(f)(17) ; IR-2006-192
	Single cash contribution of $250 or more	Written acknowledgment from the charity. §170(f)(8)
	Payroll Deduction	Pledge card *and* W-2, paystub, etc. §1.170A-13(c); Notice 2008-16
NONCASH	Non-cash contributions less than $250	Written acknowledgment from the charity or other reliable record. §1.170A-13(b)(1)
	Non-cash contribution of $250 but not more than $500	Written acknowledgment from the charity. §1.170A-13(b)(3)
	Non-cash contribution over $500 but not more than $5,000 §170(e)(12)	Written acknowledgment from the charity and form 8283, part A. §1.170A-13(b)(3)
	Non-cash contribution of over $5,000 of similar items	Written acknowledgment from the charity, appraisal and form 8283, part B. §170(f)(11)(c)
	Non-cash contribution of more than $500,000	Written acknowledgment from the charity, appraisal and form 8283, part B. Attach appraisal to the return. §170(f)(11)(D)
OTHER GIFT	Non-cash contribution of auto, boat or airplane with a value of more than $500	Written acknowledgment from the charity. Attach form 1098-C and form 8283 to return. §170(e)(11)(c); IR-2006-172
	Non-cash contribution of publicly traded stock	Written acknowledgment from the charity and form 8283, part A. §1.170A-13 (c)(7)(xi)(B)
	Non-cash contribution of privately traded stock of more than $5,000	Written acknowledgment from the charity, and form 8283 part B. If the privately traded stock is valued at $10,000 or more, attach an appraisal to the return. §1.170A-13 (c)(2)(ii)(B)(1)
	Non-cash contribution of art valued at more than $20,000	Written acknowledgment from the charity, appraisal, form 8283, part B. Appraisal and a photo of the art must be attached to the return. Rev. Proc. 96-15.

The written acknowledgment must be received from the charity before the due date of the return (including extensions) and it must include a statement regarding goods and services received in exchange for the contribution.

Appraisal Required When Aggregate of Non-Cash Items of Similar Nature Exceeds $5,000 (Notice 2006-96).

As mentioned previously, if a deduction is claimed for a contribution of non-cash items valued at more than $5,000, the taxpayer must obtain an appraisal of the donated item. All similar property donated to one or more charities must be aggregated and treated as one property for purposes of the $5,000 appraisal requirement (§170(f)(11)(F)). Page 2 of Form 8283 is used for this purpose.

> **Example**: Sharon is retiring. She donates all of her furniture to the Salvation Army and the Goodwill. If the furniture is valued at more than $5,000, Sharon will need an appraisal of all the items donated, even though the total to each charity was under $5,000.
>
> **Preparer point**. When large non-cash donations are involved, it will be important to ask the client what specific items were donated. Don't call the contribution simply "household goods." More definition may avoid reaching the $5,000 limit.

The Pension Protection Act provided statutory definitions of a "qualified appraisal" and "qualified appraiser" for appraisals prepared with respect to returns filed after August 17, 2006 (amended §170(f)(11)(E)).

What is a qualified appraisal? The term "qualified appraisal" means an appraisal that is:

1. prepared no earlier than 60 days prior to the donation nor later than the extended due date of the tax return for the year of the donation,
2. conducted by a qualified appraiser in accordance with generally accepted appraisal standards, and
3. not prepared for a fee based on a percentage of the appraised value of the donated item (§170(f)(11)(E)(i)).

Who is a qualified appraiser? The term "qualified appraiser" means an individual who:

1. Has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations,
2. Demonstrates verifiable education and experience in valuing the type of property subject to the appraisal,
3. Regularly performs appraisals for which the individual receives compensation, and
4. Has not been prohibited from practicing before the IRS at any time during the three-year period ending on the date of the appraisal (§170(f)(11)(E)(ii)).

What must be included in the qualified appraisal? The actual appraisal is required to include all of the following information:

1. A detailed description of the property,
2. If tangible personal property, the property's physical condition,
3. The date of the donation,
4. Terms of any agreement between the donor and the donee regarding the use or disposition of the donated property,
5. The name address, and ID number of the appraiser,

6. The appraiser's qualifications including education, experience and memberships in appraisal organizations,
7. A statement that the appraisal is to be used for income tax purposes,
8. The date the property was appraised, and
9. The fair market value of the donated property on the date of the contribution (§1.170A-13(c)(3)).

In addition, the appraiser must include on his or her appraisal summary a declaration that the appraiser may be subject to a penalty if a substantial or gross valuation misstatement results from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund.

Incomplete Appraisals and Improper Receipts Made Noncash Charitable Contributions Nondeductible (*Newton J. and Vonise Friedman v. Comm.*, TCM 2010-45)

Donation of $435,000 of medical equipment supported by "I almost had that receipt thing right." Newton and Vonise Friedman donated, and claimed as non-cash charitable deductions, $217,500 of diagnostic and laboratory equipment to Global Operations and Development (Global) in 2001 and another $217,500 in 2002. In 2001, they attached one Form 8283 with an appraisal from Garson Shulman, a second Form 8283 with an appraisal from Jack LeVan and a third Form 8283 summarizing the two Form 8283s. They also attached a receipt from Global, but only for the items covered by the Shulman appraisal. In 2002, they attached one Form 8283 with three different appraisals from John Levan, Jack Levan, and David Handelman. They again attached a receipt from Global, but only for the items covered by the John Levan appraisal. The Friedmans conceded that they had not strictly complied with the required recordkeeping rules when donating non-cash contributions of over $5,000 of similar items (§1.170A-13). However, they contended that they were still entitled to the claimed charitable contribution deductions because they had "substantially complied" with the regulations.

The substantial compliance doctrine as it applies to charitable contributions. Under the substantial compliance doctrine, the Tax Court has ruled that the §1.170A-13 charitable contribution reporting requirements are directory, not statutory and regulatory, and require only substantial compliance, e.g.,"to the substance or essence of the statute" (*Bond v. Comm.,* 100 T.C. 32 (1993) (quoting *Sperapani v. Comm.,* 42 T.C. 308 (1964)); *Taylor v. Comm.,* 67 T.C. 1071 (1977)).

Even though the Friedmans claimed that they had substantially complied, the Tax Court denied Friedmans their charitable contribution deduction because, unlike *Bond, supra,* who merely failed to attach a qualified appraisal, the court ruled that the Friedmans never obtained "timely and complete qualified appraisals." The two written appraisals did not appraise all of the donated equipment, and did not indicate the valuation method used. The Friedmans did not provide to the appraisers documents that adequately described, and stated the condition of, the equipment, nor did they provide information about the manner of acquisition of the donated items and their cost or other basis. Lastly, the contemporaneous written acknowledgment from Global did not meet the requirements of the regulations.

- *Henry R. Lord v. Comm.*, TCM 2010-196, conservation easement denied due to lack of qualified appraisal.

IRS Torches Donation of House to Fire Department as Appraisal was Deficient (*James Hendrix v. USA*, U.S. District Court, So. Dist. Ohio, East. Div.; 2:09-cv-132, July 21, 2010)

After owning a lot in Upper Arlington, Ohio for a number of years, James and Lori Hendrix decided to demolish the house that existed on that lot and construct a new house. They contacted Lyndon Nofziger of the Upper Arlington Fire Division to discuss the city using their house for training and then demolishing the house. The Hendrix's also retained the accounting firm of Deloitte & Touche regarding a possible donation of the house to the city that would result in the city demolishing the structure and then returning the real estate back to them. In a March 2004 report, a Deloitte & Touche advisor analyzed the possible transaction and concluded, among other things, that "[d]onation of property to a fire department is aggressive and not explicitly sanctioned by the Internal Revenue Code."

Ann Ciardelli prepared an appraisal of the Sherwin Road house and property for the Hendrix,, which she signed on June 11, 2004. Her appraisal indicated a value of $520,000. On June 29, 2004, the Hendrix's then entered into a contract with the city of Upper Arlington. This agreement provided that the Hendrix's granted the city permission "to use" the Sherwin Road property and the house for purposes of Fire Division training. The contract also provided that "[t]he structure is to be burned and/or demolished as seen fit by the Fire Division for said training." The city used the house from June 29, 2004, until October 29, 2004, at which time the house was demolished. The Hendrix's then proceeded to construct a new, larger house on their lot. They also reported a charitable contribution on their 2004 income tax return, claiming a deduction for the house in the amount of $287,400.

Appraisal was insufficient and, in addition, that there was no contemporaneous acknowledgment. The Internal Revenue Service disallowed the deduction and proceeded to assess a tax deficiency of $100,590, as the Hendrixs had not met the requirement of submitting a sufficient qualified appraisal. In addition, the Hendrixs had not received a sufficient contemporaneous acknowledgment of the donation indicating whether the city had provided any goods or services in consideration. The appraisal submitted by the Hendrix's did not contain the expected date of contribution, the terms of the agreement between the Hendrix's and the city, the qualification of the appraiser (including Ann Ciardelli's background, experience, education, and any membership in professional appraisal associations), and the required statement that the appraisal was prepared for income tax purposes.

Donor Advised Funds

Certain taxpayers may benefit from larger contributions in years of higher income. However, these same taxpayers may not be able to identify a charity or charities they want to receive such a large sum, or, taxpayer may want the charity to receive smaller gifts over time. For these clients examine the Donor Advised Funds operated by most brokerage houses, mutual funds and Community Foundations.

With these funds, the taxpayer receives a charitable deduction for the year in which he or she contributes to the fund. Subsequently, gifts are made out of the fund on the timing and in the amounts specified by the donor. Donations made from the fund are not deductible in the year in which they are made, rather the donor will have already deducted his/her donation.

> **Example.** Scott received a large severance payment from terminating his employment this year. As a result, he expects to be in the highest 35% tax bracket for this year only. Prior and subsequent years should return him to his usual 28% bracket. Scott receives solicitations several times a year from his

alma mater, State University, and he would like to make a gift to the school. However, Scott knows that if he gives the college $50,000 this year, they will expect and request a similar amount next year. Instead, Scott funds a Charitable Gift Fund through his discount broker in the amount of $50,000. He can now deduct the full amount this year, but have the fund make annual distributions to State U in smaller increments of $5,000 each year.

Furthermore, if Scott in the above example had funded his gift fund with appreciated assets, such as stock, he would have avoided paying tax on the gain on the assets as well as achieving a charitable deduction for the year of transfer.

Transfers to Donor Advised Foundation Providing Student Loans to Donor's Children not a Deductible Charitable Contribution (*Setty Gundanna and Prabhavathi Katta Viralam v. Comm.*, 136 TC No. 8, Feb 14, 2011)

"xélan," a financial planning company for doctors, provides terminal advise. Florida MD Setty Gundanna Viralam owned a 50% interest in a medical practice, which he sold in 1998 for $2,262,500, generating a taxable gain of $2,261,750 in that year. In late 1997, when negotiating the sale of his medical practice, Dr. Viralam learned of xélan, a financial planning company for doctors. xélan, also known as the Economic Association of Health Professionals, Inc., was a membership organization for doctors providing financial planning services, including pension plans, insurance products, tax reduction and asset protection strategies, and investment management. These financial services were provided through a network of xélan financial counselors. One of the financial planning strategies summarized in the xélan promotional materials was the establishment through donations to the xélan Foundation of an account that the materials characterized as a "donor advised fund" or "family public charity," by means of which a donor's donations would be segregated for investment and future distribution as the donor might recommend.

Contribution not charitable. Dr. Viralam claimed a charitable contribution after the transfer of appreciated stock to the donor advised foundation with the understanding it would provide student loans to his children, and provide compensation to family members for doing charitable services. The court denied the deduction, and penalized Dr. Viralam, because the promoter's claims were "too good to be true." Although the xélan Foundation was recognized by the IRS as a §501(c)(3) tax-exempt organization, that recognition did not mean the transfer was a charitable contribution as the court determined Dr. Viralam did not relinquish dominion and control over the assets. Instead he made the transfer with the expectation that the xélan Foundation would make educational loans to his children, which in fact it did. That's not a charitable contribution. Dr. Viralam also understood that the xélan Foundation would allow members of his family to earn compensation by performing unspecified charitable services for the foundation.

Receipt improper. In addition, the transfer failed as a charitable contribution due to a lack of substantiation because the xélan Foundation failed to acknowledge in writing that Dr. Viralam would receive no goods and services (i.e., the student loans) in exchange for the contribution. As a result, Dr. Viralam was precluded from deducting the contribution, and he had to pay tax on the subsequent sale of the stock by the foundation.

CASUALTY AND OTHER LOSSES §165

The General Rule on Casualty Losses

Casualty loss deduction rules. Certain losses sustained during the year and not compensated for by insurance or otherwise are deductible (§165(a)). In the case of an individual, this deduction shall be limited to--

- losses incurred in a trade or business;
- losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- except for the casualty losses limitations (e.g., the §165(h) $100 and 10% limitation rules), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft (§165(c)(3)).

Burden of proof. The taxpayer has the burden of proving that a casualty or theft has actually occurred. This is usually established by a police report of the investigation showing that breaking and entering actually occurred.

Amount over $100 and over 10% AGI. The amount of the deduction for personal casualty or theft losses is limited to the amount of each loss in excess of $100. The $100 floor on theft losses is applied in the same manner as the $100 floor on personal casualty losses. Also, the amount that may be claimed for all casualty and theft losses for the year is subject to the 10-percent-of-adjusted-gross-income limitation. The amount of the loss to be deducted is measured by the fair market value of the property at the time of the theft, but not in excess of its cost or other adjusted basis (which also must be proven by the taxpayer), reduced by any insurance received.

Definition of casualty. The loss must arise from an event that is identifiable, damaging to property, sudden, unexpected, and unusual in nature.

A casualty loss is limited to the decline in a property's fair market value resulting from a natural disaster that is directly linked to actual physical damage to the subject property and does not include any diminution in fair market value attributable to buyer resistance.

Deductible in year sustained. Generally, a casualty loss is deducted in the year the loss is sustained. A loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. In circumstances where the full extent of the loss is not known, the deduction can be claimed in a subsequent year. However, one's entitlement to a casualty loss deduction cannot be postponed beyond the year in which the full extent of the loss is known.

Promises of restitution. In addition, a casualty or theft loss deduction will be denied where, in the year of discovery, there is a claim for reimbursement and a reasonable prospect of recovery (§1.165-1(d)). Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim.

If the party criminally misappropriating an advance or down payment promises to make restitution, and there is a reasonable prospect that he or she will do so, there is no theft loss. Rather, a debtor-creditor relationship is established and any subsequent failure of the party to make restitution may result only in a bad debt (*Douglas County Light and Water Co. v. Comm.,* (CA-9), 2 USTC ¶583))

> **Note:** For example, a manufacturer was not allowed a loss deduction or business expense deduction as reasonable recovery was expected (CCA 200725031).

Promise of partial restitution. If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs.

> **Example.** If property having an adjusted basis of $10,000 is completely destroyed by fire in 2011, and if the taxpayer's only claim for reimbursement consists of an insurance claim for $8,000 which is settled in 2012, the taxpayer sustains a loss of $2,000 in 2011. However, if the taxpayer's automobile is completely destroyed in 2011 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of $5,000 and the taxpayer secures a judgment of $4,000 in 2012, $1,000 is deductible for the taxable year 2012. If in 2013 it becomes reasonably certain that only $3,500 can ever be collected on such judgment, $500 is deductible for the taxable year 2013… .

Theft losses. Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss (§165(e)). A theft loss is not deductible for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss (§1.165-8(a)(2)). To claim the loss, the taxpayer must show that the property was actually stolen, and the amount of the loss.

Theft defined. A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. The term "theft" includes, but is not necessarily limited to, larceny, embezzlement, and robbery. Whether a theft has been committed generally depends on the law of the jurisdiction in which the alleged theft occurred, but kidnaping ransom payments, where exacting such payments did not amount to theft, as defined by state law, have been held to be deductible as a theft loss. In addition, criminal intent is a necessary element of the crime of theft and must exist for the event to qualify as a theft loss (*William J. Powers v. Comm.*, 36 TC 1191). For example, no theft loss deduction is allowed if the purported thief has a claim to the property in question because there is no criminal intent.

Mysterious disappearance. There is no theft loss deduction for the mere mysterious disappearance of property absent direct evidence or sufficient circumstantial evidence indicating that it is more probable than not that a theft loss has occurred (*Ernest Turner v. Comm.,* 9 TCM 883). Losses due to mislaying or losing articles cannot be deducted. For example, (1) a deduction was disallowed for the alleged theft of a $2,400 brooch from taxpayer's blouse while she was at an art gallery, the evidence not being sufficient to show that the brooch was stolen rather than lost (*Mary Frances Allen v. Comm.,* 16 TC 163); (2) when baggage was loaded onto a vessel that sailed without the taxpayer and the baggage was never recovered, theft could not be presumed and the loss was not deductible (*Mildred Bauman Malley v. Comm.,* 10 TCM 31); and (3) the loss of a wallet was not deductible on the mere suspicion of theft (*Paul Bakewell, Jr. v. Comm.,* 23 TC 803).

Abandonment losses. A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under §165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs (§1.165-2).

Casualty Loss Deduction Denied as Reasonable Prospect of Recovery for Loss Existed *(Jon K. and Judith Cardenas Brill* v. U.S. [DC N.D. Calif.] C 10-05104 WHA, January 26, 2011, 2011-1 USTC ¶50,186)

Casualty due to negligent construction. John and Judith Brill purchased a condominium in 1999 that underwent substantial remodeling over a three-year period ending on or about January 1, 2003. The construction included installing a new kitchen, floors, and floor joists under the kitchen. In mid-2004, the Brills discovered cracks in the new kitchen cabinets caused by the kitchen floor not being level. A subsequent investigation revealed that one of the new floor joists had cracked. Their claim for refund also stated that they pursued claims related to the damage caused by the cracked joist "under their homeowners' policy with State Farm Insurance, and against the negligent contractor." The Brills "ultimately received a recovery from their own insurance company, and from the contractor's insurance companies, [but] the net recovery after payment of attorney's fees and costs was only $1,126." An appraisal report submitted with the claim for refund referenced an arbitration statement in 2007.

Taxpayers pursued reimbursement of loss and had a reasonable prospect of recovery. The Brill's claimed the loss on their 2004 tax return. Because they were in arbitration in 2007, the casualty loss claimed by the Brills was not "closed and completed" in 2004. The court pointed out that they had "a claim for reimbursement with respect to which there [was] a reasonable prospect of recovery" in 2004, *which was included in the to plaintiffs' own complaint*. Hence, the loss was not "fixed" or "closed and completed" in 2004 and the Brills were not entitled to their claimed recovery.

> **Comment.** The Brill's will be able to deduct their loss in the future when the loss is "fixed." That definitely was not 2004, and probably not even 2007, as they were still in arbitration.

Paying $250,000 to Settle Wrongful Death Lawsuit Not Deductible as a Casualty Loss (*Robert K.K. and Doris K. Pang v. Comm.*, TCM 2011-55)

Engineer hit pedestrian with his vehicle. Robert Pang, a well-known structural engineer in Honolulu, HI, was denied a $250,000 casualty loss deduction for an amount that he paid to settle a wrongful death claim stemming from a 2002 automobile accident in which he hit a pedestrian with his vehicle. The pedestrian later died as a result of the accident. In the year of payment, 2004, Robert and Doris Pang attached a Form 4684, Casualties and Thefts, to their joint Form 1040, on which they listed the $217,655 settlement payment as a casualty loss.

A payment that creates an economic loss to the taxpayer can't be called a casualty loss. Tax courts have consistently held that settlement payments which result from automobile accidents do not constitute deductible casualty losses. The Pangs' position considered equal two distinct things—the victim's casualty (which occurred when he died in 2002) and the Pangs' financial loss (which occurred when they made their payment in 2004)—but did not explain how the "casualty" of the victim results in a deductible "casualty loss" for the

Pangs under §165. To obtain the deduction the Pangs had to demonstrate that the claimed casualty loss was attributable to physical damage to their property (e.g., damage caused to their vehicle during the accident). The fact was that the Pangs' claimed loss was attributable not to property damage but to the monetary settlement of a wrongful death claim. The term "losses of property" in §165(c)(3) does not include a taxpayer's monetary payment to a third party or a decrease in the taxpayer's net worth. As a result, although the death of the pedestrian was certainly a "casualty" in the general sense of the word, and although one could say that the Pangs suffered a subsequent economic "loss" when they paid the wrongful death settlement, the payment was not a "casualty loss" within the meaning of §165(c)(3).

MISCELLANEOUS ITEMIZED DEDUCTIONS

Uniforms are Deductible But Work Clothing Generally Not Deductible.

Generally the cost of work clothing and related laundry is not deductible as such clothing is not a uniform, but instead is work clothing customarily worn in the employment and selected by the taxpayer for his or her own convenience in performing services (*J.G. Russell*, 11 TCM 334).

Uniforms: In order for the cost and maintenance of uniforms to be deductible as business expenses, (1) the uniforms must be of a type specifically required as a condition of employment, ***(2) they must not be adaptable to general or continued usage to the extent that they take the place of ordinary clothing*** and (3) they are not so worn (*B.D. Pevsner*, 80-2 USTC ¶9732). Special clothing was allowed for a leather uniform that carried the company logo (*L.K. Williams*, TC Memo 1991-317, aff'd, CA-9 (unpublished opinion 6/23/93)).

> **Example.** Even though a union required a painter to wear a certain type of work clothing, the cost and maintenance of the clothing were not deductible as a business expense (Rev. Rul. 57-143).

Safety clothing. An exception to the adaptable test (# 2 above) exists for clothing worn to protect from possible injury, such as steel-toed shoes (*H. White*, TC Memo 1974-146).

Military clothing. Military uniforms and maintenance thereof are only deductible if local military regulations prohibit their off-duty wear (Rev. Rul. 67-115; *B.F. Hatch*, TC Memo 1976-384). A Reservist who is required to wear his uniform and who is prohibited by military regulations from wearing his uniform except on active duty for training, attending service schools or attending training assemblies may deduct the cost and maintenance, reduced by any nontaxable uniform allowance received (Rev. Rul. 76-453).

Costumes. Cost of clothing wardrobe used in a television series program was deductible by Ozzie and Harriet Nelson, but limited as they failed to maintain adequate records that personal use did not occur (*Nelson v. Comm.*, TC Memo 1966-224). Expenses of wigs and costumes are deductible (*Reginald Denny v. Comm.*, 33 BTA 738).

Ohio TV New Anchor Denied Deduction for Clothing, Makeup, and The Cosmopolitan (*Anietra Y. Hamper v. Comm pro se*., TCS 2011-17)

TV anchor wore her business clothing only at work and separated her business and personal clothing at home. Anietra Y. Hamper, a Columbus Ohio WBNS TV (Channel 10) television news anchor, deducted unreimbursed employee business expenses for clothing, a cell phone, mileage expenses, professional expenses, subscriptions, union dues, supplies, promotional products, legal expenses, hair, nail, and makeup

expenses, office expenses, dry cleaning costs, educational and self-defense class costs, and internet expenses. As a morning and noon television news anchor, Ms. Hamper, was required to maintain a specified professional appearance as described in the Women's Wardrobe Guidelines (guidelines).

Clothing and accessory costs. The rules for determining whether the cost of clothing is deductible as an ordinary and necessary business expense are: (1) the clothing is required or essential in the taxpayer's employment; (2) the clothing is not suitable for general or personal wear; and (3) the clothing is not so worn.

Clothing must be "outrageous" to be unsuitable for everyday personal wear. Ms. Hamper's clothing deductions for work consisted of such items as traditional business suits, lounge wear, a robe, sportswear, active wear, lingerie, cotton bikini and cotton thong underwear, and evening wear. She also deducted expenses for an Ohio State jersey, jewelry, bedding, running and walking shoes, and dry cleaning costs. Ms. Hamper used a self-described criterion for determining whether a clothing expense was deductible. She would ask herself "would I be buying this if I didn't have to wear this" to work, "and if the answer is no, then I know that I am buying it specifically" for work, and therefore, it is a deductible business expense. The court ruled that Ms. Hamper did not satisfy the requirement that her clothing not be suitable for everyday personal wear. The court stated "although she was required to purchase conservative business attire, it was not of a fashion that was outrageous or otherwise unsuitable for everyday personal wear." It was evident to the court that Ms. Hamper's clothing was in fact suitable for everyday wear, even if not so worn, and was inherently personal expenses.

Contact lenses, makeup, and grooming expenses. Ms. Hamper claimed that she wore a different contact lens prescription for work that enabled her to read the teleprompter. The court felt she did not present any credible evidence to back up that claim and did not obtain an additional prescription. Ms. Hamper also purchased makeup, testifying that the makeup was designed for on-the-air appearances and provided significantly more coverage than ordinary makeup. As the receipts did not indicate the purchases were for special makeup designed for on-camera use, but simply indicated purchases for ordinary makeup suitable for everyday wear, the Court could not determine if the makeup was primarily for business use. The court also ruled that Ms. Hamper's payments for manicures, grooming, teeth whitening, and skin care were inherently personal expenditures. The fact that her employment contract with the station required her to maintain a neat appearance did not elevate these personal expenses to a deductible business expense (similarly held in *Hynes v. Comm.*, 74 T.C. 1292 for another TV news anchor).

Self-defense class expenses. Ms. Hamper's position as a news anchor made her a public figure in her local area. She was one of the unfortunate public figures affected by stalking and was advised by the local police to undertake self-defense classes as a protective measure. Ms. Hamper did not convince the Court that her gym membership fees were related to her business, or that they were otherwise an ordinary and necessary business expenses for her position as a news anchor.

Professional associations and dues and legal fees. The court permitted professional dues, e.g., $50 to the National Academy of Television Arts and Sciences, being satisfied that they were substantiated ordinary and necessary business expenses. The legal fees were also permitted as a business expenses.

Cosmo, Nickelodeon, Newspaper, Cable and Internet subscriptions. Being expected to have constant access to news, Ms. Hamper subscribed to cable television and Internet, newspapers, magazines such as Cosmopolitan, Glamour, Newsweek, and Nickelodeon, and satellite radio. The court pointed out that subscribing to periodicals of general interest does not generate a §162 ordinary and necessary business

expense. The Court referenced a prior Court of Appeals case in which the purchase of general circulation newspapers is a personal expense that taxpayers may not deduct (*Stemkowski v. Comm.*, 690 F.2d 40, 47 (2d Cir. 1982), affg. in part and revg. in part 76 T.C. 252 (1981)). The Court held that basic cable television, similar to daily newspapers, contains a significant amount of information which is inherently personal.

But, subscription expenses with respect to trade and professional magazines relating to a taxpayer's trade or business may be deductible (see *Kasey v. Comm.*, 54 T.C. 1642, 1650 (1970), affd. 457 F.2d 369 (9th Cir. 1972). As with the purchase of a television or television repair, the Court ruled that cable television access was not deductible, as Ms. Hamper failed to show that her use of the cable television and satellite radio were ordinary and necessary business expenses. In addition, she failed to demonstrate that her newspaper and magazine subscriptions served a valid business purpose for her position as a news anchor.

Continuing Education Expenses Cannot Qualify The Taxpayer For A New Trade

Expenses for education are deductible as business expenses if they:

- Maintain or improve the worker's skills, or
- Meet the express requirements of the employer or law,

but only if these expenses are not:

- Required to meet the minimum education requirements for qualification in the profession, or
- Qualify the taxpayer for a new trade or business (§1.162-5(a)).

This includes seminar expenses, convention registration, and self-study courses. But, generally the taxpayer must establish by evidence that he or she is in the related trade or business before any expenses, including educational expenses, are deductible (*Link v. Comm.,* 90 TC 460 (1988)).

Deductible educational expenses does not include high school, college courses, and most pre-licensing courses such as real estate salespersons and brokers pre-licensing courses, EA preparatory courses, CPA review courses and Bar cram courses as all of these expenses qualify the taxpayer for a new trade or business.

Test: "job performed before and after." Whether an education qualifies a taxpayer for a new trade or business depends upon the tasks and activities he or she was qualified to perform before the education and those that he or she was qualified to perform afterwards. The Court has repeatedly disallowed education expenses where the education qualifies the taxpayer to perform "significantly" different tasks and activities.

Gambling Losses

Recordkeeping Regarding Wagering Winnings and Losses (Rev. Proc. 77-29)

General recordkeeping rules. Rev. Proc. 77-29 provides guidelines regarding the responsibility for maintaining adequate records to support wagering winnings and losses. These recordkeeping suggestions are intended as general guidelines to assist taxpayers in establishing their reportable gambling gains and deductible gambling losses. While following these will enable most taxpayers to meet their obligations under the Internal Revenue Code these guidelines cannot be all inclusive and the tax liability of each depends on the facts and circumstances of particular situations (Rev. Proc. 77-29, Sec. 4).

An accurate diary or similar record regularly maintained by the taxpayer, supplemented by verifiable documentation will usually be acceptable evidence for substantiation of wagering winnings and losses. In general, the diary should contain at least the following information:

1. Date and type of specific wager or wagering activity;
2. Name of gambling establishment;
3. Address or location of gambling establishment;
4. Name(s) of other person(s) (if any) present with taxpayer at gambling establishment; and
5. Amount(s) won or lost (Rev. Proc. 77-29, Sec. 3).

Verifiable documentation for gambling transactions includes but is not limited to Forms W-2G; Forms 5754, Statement by Person Receiving Gambling Winnings; wagering tickets, canceled checks, credit records, bank withdrawals, and statements of actual winnings or payment slips provided to the taxpayer by the gambling establishment.

Where possible, the diary and available documentation generated with the placement and settlement of a wager should be further supported by other documentation of the taxpayer's wagering activity or visit to a gambling establishment. Such documentation includes, but is not limited to, hotel bills, airline tickets, gasoline credit cards, canceled checks, credit records, bank deposits, and bank withdrawals. Additional supporting evidence could also include affidavits or testimony from responsible gambling officials regarding wagering activity.

Requirements to Become a Professional Gambler

Professionals deduct losses "above the line" whereas nonprofessionals get stuck with "below-the-line." If a taxpayer is engaged in a trade or business of gambling, wagering losses, to the extent deductible under §165(d), are deducted in computing adjusted gross income (see §62). On the other hand, if the taxpayer is not in a trade or business of gambling, wagering losses, to the extent deductible under §165(d), are deductible as an itemized deduction in the computation of taxable income.

> **Example:** The IRS, in audit, allowed Thomas and Christine Dawson to deduct $208,420 of slot machine losses to offset the same $208,420 of casino jackpot winning, but only as itemized deductions. Because of the phase outs and AGI "haircuts," the IRS disallowed a $490 tuition deduction, disallowed job-related and miscellaneous expenses of $4,178. The AGI limits also reduced itemized deductions by $6,267 and personal exemptions by $6,200. Additional tax due was $4,190. Thomas and Christine only contested the propriety of increasing their adjusted gross income. They didn't contest the accuracy of the computational adjustments that flow from increasing their adjusted gross income. Sorry, the court ruled that their gambling losses were only allowable as an itemized deduction to the extent of gambling winnings, because they were not engaged in the trade or business of gambling (*Thomas Patrick and Christine E. Dawson v. Comm.*, TCS 2008-17; also, see: *Ali & Arlene Mohammadpour v. Comm.*, TCS 2007-163, which created $1,410 of additional tax due because of the phase out of other itemized deductions and a phase out of the child tax credits claimed on the tax return).

So what must a gambler do to reach the level of being a professional? For gambling to reach the level of a trade or business activity it must be "pursued full time, in good faith, and with regularity, for the production of income for a livelihood, and * * * not a mere hobby" (*Comm. v. Groetzinger*, 480 U.S. 23, 35 (1987)). The

Supreme Court, in *Groetzinger*, held that a taxpayer who spent between 60 and 80 hours per week at dog races qualified as a professional gambler even though the taxpayer received income during the year from interest, dividends, capital gains and salary earned before his job was terminated. Likewise, a taxpayer who spent 35 hours a week at a horse track after losing his job as a salesman and who was seeking a new sales job (where, at the track?) qualified as a professional gambler for purposes of §162 (*Rusnak v. Comm*., TCM 1987-249). A truck driver who averaged 40 hours per week betting on horse races at Yonkers Raceway and who prepared his own detailed "speed figures" also qualified as a professional gambler (*James Castagnetta v. Comm*., TCS 2006-24).

Most gamblers are not professional. In most cases, though, the taxpayer is unsuccessful in convincing the court the taxpayer has a bona fide intent of making a profit (e.g., *Jose Calvao v. Comm*., TCM 2007-57, slot machine player with $132,000 of W-2G's failed to convince court he wasn't gambling for recreational and entertainment purposes; *Pansy V. Panages v. Comm*., TCS 2005-3, a full-time florist who spent evenings playing the slot machines failed to convince the court that she desired to make a profit gambling; *Thomas L. Pias v. Comm*., TCS 2005-138, a retired accountant going to casino 2 to 3 times a week as he "was in what I thought was a lucky streak" not considered a professional gambler as the court was not satisfied that he looked to the gambling activity as a source of production of income for his livelihood; *Michael Merkin v. Comr*., TCM 2008-146, player club points don't help Park Avenue Psychiatrist convert gambling activity into trade or business.)

Professional Horse Racing Gambler Permitted to Deduct Business Expenses That Create a Loss (*Ronald Andrew Mayo and Leslie Archer Mayo v. Comm*., 136 TC No. 4 (Jan. 25, 2011))

Ronald Mayo reported his gambling activity on his 2001 Schedule C. He tried to deduct the entire $22,265 loss against his other income. The IRS denied the $22,265 loss on the grounds that §165(d) doesn't allow gambling losses to be used against non-gambling income. The issue was: does the §165(d) loss limitation apply *only* to direct gambling winnings or does it also apply to other gambling expenses?

			Taxpayer	IRS	Court
Gross Receipts	$120,463				
Wagers	$131,760				
Net losses from gambling:			($ 11,297)		
Business expenses					
Car and Truck		$3,109			
Interest		$ 91			
Office		$ 256			
Travel		$ 776			
Meals & Entertainment		$1,651			
Telephone & Internet		$ 670			
Admission/Entry Feed		$1,251			
Subscriptions		$1,056			
Handicapping Data		$1,960			
ATM Fees		$ 148			
TOTAL			($10,968)		
Schedule C Gambling Losses			($22,265)		
§165(d) Gambling Loss Limitation			-0-	$22,265	$11,297
Schedule C Losses deductible against other income			$22,265	-0-	$10,968

The IRS conceded Ronald was in the trade or business of gambling on horse races. And the court emphasized that §165(d), which limits wagering losses to the amount of wagering gains, trumps the general language of §162(a), which allows deductions for ordinary and necessary business expenses. Therefore, the court held that Ronald's wagering expenses of $131,760 constituted losses from wagering transactions that were limited by §165(d) to the gains he reported from wagering ($120,463), notwithstanding Ronald's engagement in the trade or business of gambling. The IRS's disallowance of $11,297 of Ronald's claimed loss was correct.

Next, the court had to decide whether the §165(d) limitation on "Losses from wagering transactions" extended to Ronald's $10,968 of wagering expenses. The IRS, relying on *Offutt v. Comm.,* (16 TC 1214 (1951)) and *Estate of Todisco v. Comm.,* (757 F.2d 1(1st Cir. 1985)), argued that "Losses from wagering transactions" covers both, so that Ronald could not deduct either the $11,297 excess of his wagering expenses over gambling gross receipts or the $10,968 in business expenses he claimed in connection with carrying on his gambling business. *Offutt* and *Estate of Todisco* held that §165(d) limits amounts expended on wagers as well as other expenses incurred in carrying on the trade or business of gambling, such as a bookmaker's mailing, printing, and stenographic expenses (*Offutt*), or his State taxes on wagering (*Estate of Todisco*). This court, pointing out that *Offutt* offered no reasoning to support their conclusion, and held that reconsideration of *Offutt's* interpretation of "Losses from wagering transactions" was warranted. Then it concluded that *Offutt* should no longer be followed. The court stated that "Generally, it is not sufficient that the gain arise merely in connection with the conduct of wagering activities; the gain must be the direct result of a wager entered by the taxpayer." Thereafter, the court held that Ronald was entitled to deduct under §162(a) the $10,968 in business expenses claimed in connection with carrying on his gambling business.

TAX CALCULATION

ALTERNATIVE MINIMUM TAX AND EXEMPTIONS §56

AMT Rates

Graduated rate schedule. A two-tiered, graduated rate schedule for AMT is applicable to noncorporate taxpayers. The lower tier consists of a 26% rate, applicable to the first $175,000 of a taxpayer's AMTI in excess of the exemption amount. The upper tier consists of a 28% rate, applicable to AMTI that is greater than $175,000 above the exemption amount. For married individuals filing separately, the 28% rate applies to AMTI that is greater than $87,500 above the exemption amount.

The AMT Exemption

Ever since EGTRRA 2001 when Congress reduced regular income tax brackets, a growing time bomb has been waiting to go off in the alternative minimum tax. To lengthen the fuse and delay detonation, the legislature has instituted what has come to be commonly referred to as the "patch."

> **Comment.** The patch has not disarmed the bomb, merely delayed the inevitable. By enacting annual, temporary increases in the minimum tax exemption amounts, Congress prevents tens of millions of taxpayers from falling prey to the AMT without ever addressing the real problems in the system. Moreover, while early years were "fixed" by May or June, in 2007 and 2008 Congress waited until late in the year to relieve more than 20 million taxpayers. How do tax professionals provide planning guidance in this environment? Do you ask your clients "Do you feel lucky?"

Two-year AMT Patch

Without the AMT "patch," a taxpayer would have received an exemption of $33,750 (individuals) and $45,000 (married filing jointly). In addition, nonrefundable personal credits would not have been allowed against the AMT. The 2010 Tax Relief Act increases the exemption amounts for 2010 to $47,450 (individuals) and $72,450 (married filing jointly) and for 2011 to $48,450 (individuals) and $74,450 (married filing jointly). The 2010 Tax Relief Act also permits nonrefundable personal credits to be used against the AMT. The 2010 Tax Relief Act is effective for taxable years beginning after December 31, 2009.

AMT		2009	2010	2011	2012 (without patch)
Unmarried	Exemption amt: Phaseout range:	$46,700 $112,500- $299,300	$47,450 $112,500- $302,300	$48,450 $112,500- $306,300	$33,750 $112,500- $247,500

Married filing joint	Exemption amt: Phaseout range:	$70,950 $150,000- $433,800	$72,450 $150,000- $439,800	$74,450 $150,000- $447,800	$45,000 $150,000- $330,000

Planning point. If the tax professional prepared a client tax projection earlier in the year, it is likely the tax planning software used lower AMT exemption numbers and indicated the client was well into AMT. The tax projection needs to be redone.

Planning point. The "AMT patch" means that clients who have similar income and deductions in 2010 and 2011 and were not in AMT in 2010 will find themselves out of AMT in 2011.

Top 10 AMT Preference Items

Although there are nearly thirty different preference or adjustment items that contribute to the calculation of alternative minimum taxable income (AMTI), just three of these now amount to over 100%[16] of all AMT adjustments. The top 10 AMT kickers (as provided by the Department of Treasury's Office of Tax Analysis) cover the range of adjustments that we are most likely to see in our client base.

1. State and local tax deductions 71%
2. Personal exemptions 18%
3. Miscellaneous deductions 12%
4. Regular tax NOLs 7%
5. Post-1986 depreciation 1%
6. Private activity bond interest 1%
7. Incentive stock options 1%
8. Standard deduction 1%
9. Passive activity loss 1%
10. Beneficiaries of estates .5%

Nonrefundable Credits Limited in 2012 for AMT (§26(a)(2); TRA 2010)

For taxable years after 2011, an individual may not be able offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits. A "patch" is possible before year end.

Nonrefundable personal credits. Nonrefundable personal credits include the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit.

[16] The total adds to more than 100 percent because some adjustments, not shown, are negative (e.g. state tax refunds, limitation on itemized deductions).

The Minimum Tax Credit

The AMT is calculated using two types of adjustments and preferences – deferral items and exclusion items. **Deferral** items generally do not cause a permanent difference in taxable income over time. **Exclusion** items, on the other hand, do cause a permanent difference. The minimum tax credit is allowed only for AMT attributable to deferral items.

Examples of deferral preferences and adjustments:

Depreciation
Incentive Stock Options bargain element on exercise
Certain Passive Activity Adjustments
Adjusted Basis

The minimum tax credit cannot reduce the ***minimum tax*** in subsequent years. Instead, the credit can reduce the ***regular tax***, but not below the level of the tentative minimum tax for that year. Any unused minimum tax credit carries forward.

Allowance of Long-term Unused Credits (Emergency Economic Stabilization Act of 2008)

The Emergency Economic Stabilization Act of 2008 allows the long-term (over-three-year-old) unused minimum tax credit to be claimed over a two-year period (rather than five years) and eliminates the AGI phase-out. The provision is effective for taxable years beginning after December 31, 2007.

KIDDIE TAX (§1(g))

Age of Children for Kiddie Tax Calculation

Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 19 or is a full-time student over age 18 but under age 24 by the close of the taxable year, (2) either of the child's parents is alive at such time, and (3) the child's unearned income exceeds $1,900 (2010 and 2011), and (4) the child does not file a joint return.

Preparer Point. Disabled children are not excepted from the age test for kiddie tax purposes.

Under these rules, the net unearned income of a child (for 2010 and 2011, generally unearned income over $1,900) is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $1,900, less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.

Kiddie tax doesn't apply for child who provides own support. The expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support. Scholarships are not counted in the support test.

The exemption from the kiddie tax for 2010 is $1,900 (same in 2011). A parent is able to elect to include a child's income on the parent's return if the child's income is more than $950 (same in 2011) and less than $9,500 (same as 2011) [§1(g)(4)]

For 2010, the exemption amount for purposes of the alternative minimum tax will be the lesser of $6,700 plus the child's earned income, or $33,750 (unless patched one more time).

Planning Pointers for the 2011 Kiddie Tax
Delay collections of all unearned income until the child turns 19 or 24 if the child is a full-time student.
Borrow college funds from subsidized loan programs (where interest doesn't accrue until graduation) rather than sell stock where gains are subject to the kiddie tax.
Invest in growth stock rather than stock paying dividends including use of "tax efficient" mutual funds.
Invest in tax exempt bonds.
Invest in US savings bonds and delay cashing in the bonds until the child is out of the kiddie tax trap.
Move custodial bank accounts (CUTMA balances) into a §529 plan for the child.

Warning. Parents' tax rate will include 3.8% Medicare tax in 2013.

INDIVIDUAL TAX CREDITS

ADOPTION CREDIT AND ASSISTANCE PROGRAMS

Adoption Tax Credit Extended, Increased and Made Refundable (The Tax Reform Act of 2010; §23; §137; Notice 2010-66; IR-2010-100; Rev. Proc. 2010-31; Rev. Proc. 2010-35)

Temporarily extends the increased adoption tax credit and the adoption assistance program exclusion. Taxpayers that adopt children may receive a tax credit for qualified adoption expenses. A taxpayer may also exclude from income adoption expenses paid by an employer. The EGTRRA increased the credit from $5,000 ($6,000 for a special needs child) to $10,000, and provided a $10,000 income exclusion for employer-assistance programs. Amounts are indexed for inflation. The Patient Protection and Affordable Care Act of 2010 extended these benefits to 2011 and made the credit refundable. The 2010 Tax Relief Act extends for an additional year, through 2012, the increased adoption credit amount and the exclusion for employer-assistance programs as enacted in EGTRRA.

	2010	2011-2012	2013
Adoption Credit	$13,170	$13,360*	$5,000/$6,000
Phase-out starts	$182,520	$182,710*	$75,000
Phased out at	$222,520	$222,710*	$115,000
*2012 amount will be $12,170 indexed for inflation after 2010			

Planning point. The maximum credit is allowed for an adoption of a special needs child, regardless of the amount of adoption expense the taxpayer incurs.

Planning point. The limit applies separately to the credit and the employer benefit exclusion. In other words, as long as the adopting parent pays more than $26,340 in qualified adoption expenses, he or she can exclude an employer adoption benefit of $13,170 and he or she could claim a $13,170 adoption credit on his or her personal tax return.

Filing of Form 8839 requires the filing of a paper Form 1040 tax return (IR-2010-100). Married couples must file a joint return in order to take the credit unless the special rules for married individuals who are separated or living apart apply (§23(f)(1)). To claim the adoption credit, Form 8839, Qualified Adoption Expenses, must be completed and attached to the taxpayer's Form 1040 or Form 1040A along with one or more adoption-related documents. This documentation requirement means that taxpayers claiming the credit will have to file paper tax returns.

New! Required documentation. For a domestic adoption, attach an adoption order or decree. For a foreign adoption governed by the Hague Convention, attach a Hague Adoption Certificate, an IH-3 visa or a foreign adoption decree (translated into English). For a foreign adoption from a country not governed by the Hague

Convention, attach a foreign adoption decree (translated into English) or an IR-2 or IR-3 visa. For a special needs child, also attach a copy of the state determination of special needs.

Qualified adoption expenses – when and what. Qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging) and other expenses which are directly related to, and the principal purpose of which is the legal adoption of an eligible child by the taxpayer. All reasonable and necessary expenses required by a state as a condition of adoption are qualified adoption expenses, including the cost of construction, renovations, alterations or purchases specifically required by the state to meet the needs of the child. Expenses are not qualified adoption expenses if they are:

1. Incurred in violation of state or Federal law,
2. Incurred in carrying out any surrogate parenting arrangement,
3. Incurred in connection with the adoption by an individual of a child who is the child of such individual's spouse, or
4. Reimbursed under an employer program.

Adoption credit – when and how much. The qualified adoption credit is allowed for the taxable year following the taxable year during which the expenses (including expenses for an unsuccessful effort to adopt an eligible child) are paid or incurred. However, the credit is allowed for expenses paid or incurred during the taxable year in which *the adoption becomes final* (See Notice 97-70 and Pub. 968 for more explanation).

Foreign Adoption. For the adoption of a child who is not a citizen or resident of the United States, no credit is allowed unless the adoption becomes final. Rev. Proc. 2005-31 provides safe harbors for determining the finality of an adoption of a foreign-born child for federal income tax purposes. Furthermore, for foreign adoptions, all expenses are taken into account as if such expenses were paid or incurred during the year that the adoption becomes final (§23(e)(2)).

Six Things the IRS Wants You to Know about the Expanded Adoption Credit (IRS Tax Tip 2011-34, Adoption Benefits FAQs)

1. The credit is refundable, meaning that the taxpayer can get it even if no tax is owed.
2. The return must be paper filed. To get the credit the taxpayer must attach documents supporting the adoption.
3. Documents may include a final adoption decree, placement agreement from an authorized agency, court documents and the state's determination for special needs children.
4. Qualified adoption expenses are reasonable and necessary expenses directly related to the legal adoption of the child. These expenses may include adoption fees, court costs, attorney fees and travel expenses.
5. An eligible child must be under 18 years old, or physically or mentally incapable of caring for himself or herself.
6. If the modified adjusted gross income of the taxpayer is more than $182,710, the adoption credit is reduced. If the modified AGI is $222,710 or more, there is no credit.

AMERICAN OPPORTUNITY TAX CREDIT AND LIFETIME LEARNING CREDITS §25A

The "American Opportunity Tax Credit" (Six Facts about the American Opportunity Tax Credit, Tax Tip 2010-23; Rev. Proc. 2011-12)

Temporarily extends the American Opportunity Tax Credit. Created under the American Recovery and Reinvestment Act, the American Opportunity Tax Credit is available for up to $2,500 of the cost of tuition and related expenses paid during the taxable year. Under this tax credit, taxpayers receive a tax credit based on 100% of the first $2,000 of tuition and related expenses (including course materials) paid during the taxable year and 25% of the next $2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit is refundable. This tax credit is subject to a phase-out for taxpayers with adjusted gross income in excess of $80,000 ($160,000 for married couples filing jointly). The 2010 Tax Relief Act extends the American Opportunity Tax Credit for an additional two years, through 2012.

Above-the-line deduction for qualified tuition and related expenses. The 2010 Tax Relief Act extends for two years (through 2011) the above-the-line tax deduction for qualified education expenses.

Comparisons of Major Features of the American Opportunity Tax Credit (Hope Credit) and the Lifetime Learning Credit

American Opportunity Tax Credit, Lifetime Learning Credit & Tuition Deduction Comparison			
Feature	**American Opportunity (Hope) Tax Credit**	**Lifetime Learning Tax Credit**	**Higher Education Tax Deduction**
Type of benefit	40% of the credit is refundable except if a child subject to kiddie tax claims the credit.	Nonrefundable tax credit (cannot exceed tax liability).	Above the line tax deduction (filers do not need to itemize).
Dates applicable	**Extended through 2012**	Indefinite	**Extended through 2011**
Maximum benefit	$2,500 (100% of first $2,000 in qualified expenses, 25% of second $2,000) per student.	$2,000 (20% of first $10,000 in qualified expenses) per return.	$4,000 deduction per return (but only $2,000 maximum deduction available for higher income taxpayers).

American Opportunity Tax Credit, Lifetime Learning Credit & Tuition Deduction Comparison			
Feature	**American Opportunity (Hope) Tax Credit**	**Lifetime Learning Tax Credit**	**Higher Education Tax Deduction**
Income limit	Credit begins to phase out at $80,000 modified AGI and is fully phased out at $90,000 ($160,000 and $180,000 thresholds for joint returns).	Credit begins to phase out at $51,000 modified AGI and is fully phased out at $61,000 ($102,000 and $122,000 thresholds for joint returns).	Deduction available to taxpayers with up to $65,000 in modified AGI ($130,000 for joint returns); taxpayers with modified AGI or more than $65,000 but less than $80,000 can claim smaller maximum deduction ($130,000 and $160,000 thresholds for joint returns)
Postsecondary education expenses qualifying for benefit	Tuition, fees, and course materials required for enrollment.	Tuition and fees required for enrollment.	Tuition and fees required for enrollment.
Type of postsecondary education	First 4 years of undergraduate education when enrolled on at least a half-time basis in a program leading to a degree, credential, or certificate.	For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program.	For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program.

"Qualified Costs" for Tuition Credit now Include Books (IRS Tax Tip 2010-12)

The American Recovery and Reinvestment Act of 2009 replaced the Hope Credit with the American Opportunity Credit. In addition to increasing the amount of the credit and the AGI phaseout numbers, the term "qualified tuition and related expenses" has been expanded by ARRA 2009 to include expenditures for required course materials. For this purpose, the term "course materials" means books, supplies and equipment required for a course of study. See the IRS Website for its summary of the American Opportunity Credit.

Is the IRS checking? The Treasury Inspector General performed an analysis of Forms 1098-T filed for 2005, 2006, and 2007 and found that Box 1, the actual amount paid, was blank on close to 80% of the forms. Perhaps this is why the IRS is not using the 1098-T in its matching program. It seems that educational institutions are expending 5.1 million hours and $3.8 million to mail the forms to students for little if any purpose. (Improvements are needed in administration of Education Credits).

RESIDENTIAL ENERGY EFFICIENT PROPERTY §25

2011 Energy-efficient Credit for Existing Homes (2010 Tax Relief Act)

$500 lifetime credit is back. The 2010 Tax Relief Act extended through 2011 the credit under §25C for energy-efficient improvements to existing homes, reinstating the credit as it existed before passage of the American Recovery and Reinvestment Act. Standards for property eligible under §25C are updated to reflect improvements in energy efficiency.

- The $500 lifetime credit again applies but no more than $200 of the credit can be attributable to expenses for windows.
- This $200 amount must be reduced by the aggregate amount of previously allowed credits for windows and skylights that the taxpayer received in 2006, 2007, 2009 and 2010 (§25C(b)(2)).
- The credit amount is also limited to: $50 for an advanced main air circulating fan; $150 for any qualified natural gas, propane, or oil furnace or hot water boiler; and $300 for any item of energy-efficient building property meeting minimum energy standards (electric heat pump water heater, electric heat pump, geothermal heat pump, central air conditioner, and natural gas, propane, or oil water heater).
- The $500 amount must be reduced by the aggregate amount of previously allowed credits the taxpayer received in 2006, 2007, 2009 and 2010 (§25C(b)(1)).

The maximum aggregate credit for 2006 and 2007 was $500 and $1,500 for 2009 and 2010.

> **Planning point**. The $1,500 credit available for 2009 and 2010 has expired and is replaced by a $500 lifetime credit. In other words, if the taxpayer received more than $500 of credit in any prior year, no future credit is available.

Energy-efficient new homes credit. The 2010 Tax Relief Act extended through 2011 the credit for manufacturers of energy-efficient residential homes.

Energy-efficient appliances. The 2010 Tax Relief Act extended through 2011 and modifies standards for the §45M credit for US-based manufacture of energy-efficient clothes washers, dishwashers and refrigerators.

Six Facts about the 2010 Nonbusiness Energy Property Credit (IRS Tax Tip 2011-49; Form 5695)

Taxpayers who made some energy efficient improvements to their home or purchased energy-efficient products last year may qualify for a tax credit this year. The IRS wants you to know about these six energy-related tax credits created or expanded by the American Recovery and Reinvestment Act of 2009.

1. Residential Energy Property Credit. This tax credit is for homeowners who make qualified energy efficient improvements to their existing homes. This credit is 30 percent of the cost of all qualifying improvements. The maximum credit is $1,500 for improvements placed in service in 2009 and 2010 combined. The credit applies to improvements such as adding insulation, energy efficient exterior windows and energy-efficient heating and air conditioning systems.

2. Residential Energy Efficient Property Credit. This tax credit will help individual taxpayers pay for qualified residential alternative energy equipment, such as solar hot water heaters, solar electricity equipment

and wind turbines installed on or in connection with their home located in the United States and geothermal heat pumps installed on or in connection with their main home located in the United States. The credit, which runs through 2016, is 30 percent of the cost of qualified property. ARRA removes some of the previously imposed annual maximum dollar limits.

3. Plug-in Electric Drive Vehicle Credit. ARRA modifies this credit for qualified plug-in electric drive vehicles purchased after Dec. 31, 2009. The minimum amount of the credit for qualified plug-in electric drive vehicles, which runs through 2014, is $2,500 and the credit tops out at $7,500, depending on the battery capacity. ARRA phases out the credit for each manufacturer after they sell 200,000 vehicles.

4. Plug-In Electric Vehicle Credit. This is a special tax credit for two types of plug-in vehicles — certain low-speed electric vehicles and two- or three-wheeled vehicles. The amount of the credit is 10 percent of the cost of the vehicle, up to a maximum credit of $2,500 for purchases made after Feb. 17, 2009, and before Jan. 1, 2012.

5. Credit for Conversion Kits. This credit is equal to 10 percent of the cost of converting a vehicle to a qualified plug-in electric drive motor vehicle that is placed in service after Feb. 17, 2009. The maximum credit, which runs through 2011, is $4,000.

6. Treatment of Alternative Motor Vehicle Credit as a Personal Credit Allowed Against AMT. Starting in 2009, ARRA allows the Alternative Motor Vehicle Credit, including the tax credit for purchasing hybrid vehicles, to be applied against the Alternative Minimum Tax. Prior to the new law, the Alternative Motor Vehicle Credit could not be used to offset the AMT. This means the credit could not be taken if a taxpayer owed AMT or was reduced for some taxpayers who did not owe AMT.

Caps Eliminated for Residential Alternative Energy Property (§25D)

30% credit. §25D provides a personal nonrefundable tax credit for the purchase of qualified solar electric property, qualified solar water heating property, wind energy property, and geothermal heat pumps that are installed or used in connection with the taxpayer's residence located in the US. The credit is equal to 30% percent of qualifying expenditures and expires December 31, 2016.

ARRA 2009 eliminates the credit caps for solar hot water, geothermal, and wind property and eliminates the reduction in credits for property using subsidized energy financing.

> **Example**. In 2011, Vern installed a solar hot water system in his house for a cost of $25,000. The system does not heat his pool or spa. Vern is entitled to a $7,500 credit.

Database Summarizes State and Local Energy Credits and Subsidies

The North Carolina Solar Center maintains a database for federal, state, and local renewable energy incentives and subsidies. This Website can help a client determine the net cost after incentives for a energy efficient installation.

Alternative Motor Vehicle Credit Treated as a Nonrefundable Personal Credit (§30B)

For tax years beginning in 2009, the alternative motor vehicle tax credit will be treated as a nonrefundable personal tax credit. This means that it can be used to offset regular tax liability and alternative minimum tax (AMT) liability the same as other nonrefundable personal credits to the extent permitted.

Volkswagen Joins List of Car Manufacturers Subject to Credit Phase-out (Notice 2010-42)

Credits for lean burn Volkswagens are being phased-out during 2010 and will be fully phased-out by January 1, 2011. Volkswagen sold their 60,000th qualifying lean burn vehicle in the first quarter of 2010. Accordingly, only 50% of the normal credit will be allowed to those purchasing qualified Volkswagens on or after July 1, 2010. Assuming Congress does not extend the credit beyond its current December 31, 2010 expiration date, no credit will be allowed for autos purchased on or after January 1, 2011.

Plug-in Electric Drive Motor Vehicle Credit (Chevy Volt, Tesla; Nissan Adds to List of Qualified Electric Vehicles (Notice 2009-58); §30 and §30D; see also IR-2009-45)

Nissan Cube Joins Chevy Volt and Tesla in the List of Qualified Electric Vehicles (Notice 2009-58). The latest news on the Qualified Plug-In Electric Vehicle Credit front is that Nissan has entered the electric car arena with its introduction of the Cube, set to arrive in 2010. After testing its vehicle with fleet customers, Nissan will market the electric car worldwide in 2012 to retail customers. Read more at http://www.autoweek.com/article/20080310/FREE/833121356#ixzz0O0oiUL0q.

ARRA expands definition of qualified electric plug-in vehicle. Low speed two, three, and four wheeled vehicles, such as motor scooters, purchased after Feb. 17, 2009 and before Jan. 1, 2012 will also qualify for the plug-in vehicle credit. The credit is 10% of the vehicle cost to a maximum of $2,500. To qualify, a vehicle must be a low speed vehicle propelled with a rechargeable four-kilowatt-hour battery or be a two or three wheeled vehicle propelled by a rechargeable 2.5 kilowatt hour battery. Vehicles manufactured primarily for off-road use (i.e., golf carts) do not qualify.

Amount of credit varies. For qualifying vehicles purchased in 2009, the credit is equal to $2,500 plus $417 per kilowatt hour of traction battery capacity in excess of four kilowatt hours (five kilowatt hours for vehicles purchased after Dec. 31, 2009). The maximum credit varies between $7,500 and $15,000,depending on the vehicle's gross weight and the vehicle's battery kilowatt hours.

Guidance on manufacturers required certification issued (Notice 2009-54). The guidance provides procedures that require manufacturers to submit detailed information such as the vehicle's gross weight, the number of wheels, a statement that the vehicle is propelled to a significant extent by an electric motor that draws electricity from a battery, the kilowatt hour capacity of the battery, and a statement that the battery is capable of being recharged from an external source of electricity. The IRS will review and acknowledge the certification presented by a manufacturer within 30 days of receipt of the certification.

Purchasers of a qualified electric plug-in vehicles may generally rely on a manufacturer's certification for purposes of claiming the credit. The purchaser may claim the credit in the certified amount with respect to the vehicle if the following requirements are satisfied:

- The vehicle is acquired after February 17, 2009, and before January 1, 2012;

- The original use of the vehicle commences with the taxpayer;
- The vehicle is acquired for use or lease by the taxpayer, and not for resale;
- The IRS has not withdrawn certification acknowledgment; and
- The vehicle is used predominantly in the United States.

Credit is phased out after the sale by a manufacturer of 200,000 vehicles in the U.S. In a rule similar to that of other alternative fuel vehicle credits, once a manufacturer has sold 200,000 electric plug-in vehicles, the credit is phased out: full credit for remainder of quarter that the 200,000th unit is sold and two additional quarters; 50% of credit for the next two quarters; 25% of the credit for next two quarters; and no credit beyond that.

EARNED INCOME CREDIT §32

Background of Earned Income Tax Credit

Eligible low-income workers are able to claim a refundable earned income credit. The amount depends upon the taxpayer's income and whether the taxpayer has one, two, more than two, or no qualifying children. The earned income credit is not available to married individuals who file separate returns. In addition, no earned income credit is allowed if an eligible individual is the qualifying child of another taxpayer.

Earned Income Tax Credit

2011 Earned Income Base Amounts, Credit Percentages and Phase-out Amounts (Rev. Proc. 2011-12)

The maximum 2011 earned income credit is $5,751 (married filing joint with three children). The earned income base amounts, credit percentages, and phase-out amounts are as follows:

Number of Qualifying Children	Maximum Credit	Earned income/AGI less than
No Children	$464	$13,660 ($18,740 MFJ)
One Child	$3,094	$36,052 ($41,132 MFJ)
2 Children	$5,112	$40,964 ($46,044 MFJ)
3+ Children	$5,751	$43,998 ($49,078 MFJ)

For example, in 2011, the maximum credit of $3,094 for one qualifying child is available for those with earnings between $9,100 and $16,690 ($21,770 if married filing jointly). The credit begins to phase down at a rate of 15.98% of earnings above $16,690 ($21,770 if married filing jointly). The credit is phased down to $0 at $36,052 of earnings ($41,132 if married filing jointly).

Temporarily extends third-child EITC. Working families with two or more children currently qualify for an earned income tax credit equal to 40% of the family's first $12,570 of earned income. The American Recovery and Reinvestment Act of 2009 increased the earned income tax credit to 45% of the family's first $12,570 of earned income for families with three or more children and increased the beginning point of the

phase-out range for all married couples filing a joint return (regardless of the number of children). The 2010 Tax Relief Act extends for an additional two years, through 2012, the American Recovery and Reinvestment Act provisions that increased the credit for families with three or more children and increased the phase-out range for all married couples filing a joint return.

Disqualified Income Amount is $3,150 in 2011 (§32(i))

No earned income credit is allowed if the taxpayer has disqualified income in excess of $3,150 for the taxable year.

2011 BUSINESS TAX UPDATE

CHAPTER HIGHLIGHTS

- *New!* Credit for small businesses who provide health insurance for employees
- *New*! Employer retention credit applies for 2011
- *New*! !099 reporting for corporations and landlords repealed
- *New!* 2011 credit card reporting rules begin in 2011
- *New!* Simple cafeteria plan begins in 2011
- *New!* 100% bonus depreciation goes through 2011
- *New!* $500,000 §179 expensing election extended through 2011
- *New!* §179 allowed for real property expires at end of 2011
- *New!* Cell phones no longer listed property
- *New!* 5 year carryback allowed for general business credits
- *New*! Immediate deduction for start up expenses expanded

NEWS FOR BUSINESS CLIENTS

Congress Repeals Expanded 1099 Reporting (The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011)

The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 was signed into law by President Obama on April 14, 2011. The legislation repeals two controversial Form 1099 reporting provisions that would have required (1) landlords to issue forms 1099 to service providers paid $600 or more in a year and (2) all businesses that paid $600 or more to a corporation for goods and services to file a form 1099 on the payments.

***New!* 2011 Credit Card Reporting Rules (Form 1099-K, NPRM Reg-139255-08).**

Will this help find unreported income? For reportable payment transactions for calendar years beginning after December 31, 2010, any payment settlement entity (Visa, Paypal, etc.) making payment to a merchant in settlement of reportable payment transactions (including credit cards, debit cards and stored-value cards, such as gift cards and FSA/HRA cards) is required to report annually to the IRS and to the merchant payee the gross amount of such reportable payment transactions, as well as the name, address, and TIN of the participating payees (see new §6050(w) added by the Housing and Economic Recovery Act of 2008). Backup withholding rules (which require withholding for certain reportable transactions when there is an incorrect taxpayer identification number or TIN) apply to amounts paid after December 31, 2011.

Form 1099 will report monthly payments. To accommodate fiscal year businesses, the proposed regulations require reporting of the aggregate reportable payment transactions for the calendar year and for each month of the calendar year.

Small business exemption. A de minimis exception to credit card reporting applies if the aggregate value of the transactions by the merchant do not exceed $20,000 and if the aggregate number of transactions does not exceed 200 in the calendar year.

According to IRS Commissioner Douglas Shulman, the IRS plans to use its administrative authority to exempt from the new Form 1099 reporting requirement business transactions conducted using credit and debit cards. These transactions will already be covered by reporting requirements on payment card processors, so the IRS sees no need for businesses to report them as well. So, when a business uses a credit or debit card, there will be no additional burden under the new law. (Remarks by IRS Commissioner Shulman to American Payroll Assn., May 27, 2010).

Segregate cash and credit card sales on the books. When the tax practitioner prepares a 2011 business tax return, the practitioner should report the credit/debit card sales separately from cash sales (Remarks by IRS Commissioner Shulman to American Payroll Assn. May 27, 2010). This new 1099 reporting will allow the IRS to see if the credit card dollar figure reported on the tax return matches the bank's information return, and also see if the amount of revenue from credit cards makes sense in the context of the firm's overall business.

> **Chart of accounts need to be revised.** Therefore, beginning in 2011, the business should revise its chart of accounts to segregate credit/debit card sales from cash sales (including checks from the customer) as these two revenue numbers will be entered separately on the 2011 tax return.
>
> **Comment.** Hello to more CP-2000 matching letters from the IRS.

BUSINESSES AND HEALTH RELATED BENEFIT PROGRAMS

ACCIDENT AND HEALTH PLANS §35; §105, §106 & §125

Health Related Fringe Benefits/Deductions

Several Internal Revenue Code sections provide preferential medical related deductions, employee tax-free fringe benefits, income exclusions and other tax incentives to encourage employers to provide medical benefits to employees and to create parity for employers regardless of which entity type they chose. §104, §105, §106, §162(l) and §223 all have provisions impacting employers and/or employees in regards to their respective medical expenses. The discussion that follows addresses the various Code sections and their impact to employees, Schedule C and F owners, S corporation and C corporation shareholder employees, and partners in partnerships.

What Health Benefits Apply to Owners?

	Sch C	Sch F	1065	1120S*	1120
SE health insurance	X	X	X	X	NA
SE tax deduction?				X	NA
Tax-free health insurance					X
Medical reimbursement					X
Simple Cafeteria Plan					X

FSAs	No	No	No	No	X
HSAs	X	X	X	X	X

* If S corp shareholder is not an employee (e.g., no W-2 wages), there is no SE health insurance deduction.

Deducting Health Insurance for the Self-employed

The problem for sole proprietors. Health insurance, and medical expenses not covered by health insurance, paid by sole proprietors are generally §262(a) personal expenses, deductible "below-the-line" on Schedule A, subject to the 7.5% AGI "haircut" §213(a) limitations.

Deduct self-employed deduct health insurance "above-the-line." §162(l) permits 100% of the health insurance premiums to be deductible "above-the-line" (before AGI) with the following limitations:

- Deduction is limited to that business's earned income. The income from two businesses cannot be aggregated for income limits, although each business could pay different specific health insurance plans (CCA 200524001).

  Note: Earned income for an S corporation shareholder includes only form W-2 wages. S corporation flow through income from the K-1 is not "earned income" for these purposes (§162(l)(5)).

- Deduction is limited when taxpayer is ***eligible*** to participate in a subsidized health plan maintained by his or her employer ***or the spouse's employer*** (§162(l)(2)(A) & (B)).
- For years other than 2010, the deduction isn't available for self-employment tax purposes (§162(l)(4)).

New! **Self Employed Health Insurance Includes Premiums for Children under Age 27 Dependent Even If Not a Dependent (§162(l)(1)(D))**

The deduction for self employed health insurance includes premiums payments for the self-employed taxpayer and the taxpayer's spouse, dependents, and, effective March 30, 2010, any child (as defined in §152(f)(1)) of the taxpayer who as of the end of the taxable year has not attained age 27.

Maximize the tax benefits and reduce the after tax cost of health insurance premiums by taking out the insurance in the correct name.

ENTITY	HEALTH PLAN IN NAME OF:	REFERENCE
Sole proprietor	individual	LTR 200623001
Single member LLC (disregarded entity)	individual	LTR 200623001
Partnership or LLC	partner or company	Rev. Rul. 91-26
One worker S corporation	shareholder or company	Notice 2008-1, §106

Two-or-more-worker S corporation	company	§106
C corporation	company	§106
	company	HRA, §105 non-discriminatory reimbursement plan

Health Insurance Plan in Name of 2% S Corporation Owner Can Qualify for Self Employed Health Insurance Deduction (Notice 2008-1)

Self employed health insurance deduction allowed even if the plan is in the name of the shareholder. A plan providing medical care coverage for a 2% shareholder-employee in an S corporation is *established* by the S corporation if it makes the health insurance premium payments for the policy covering the 2% shareholder-employee in the current taxable year; or if the 2% shareholder makes the premium payments and furnishes proof of premium payment to the S corporation and it then reimburses the shareholder-employee for the premium payments in the current taxable year. No deduction is allowed if the S corporation does not make the premium payments.

Premium payments are taxable wages – but not subject to FICA or FUTA. In order for the 2% shareholder-employee to deduct the amount of the health insurance premiums, the S corporation must report the health insurance premiums paid or reimbursed as wages on the 2% shareholder-employee's Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his or her Form 1040. Even though the premium payments are to be included in wages, they are not wages subject to Social Security and Medicare taxes if the requirements for exclusion under §3121(a)(2)(B) are satisfied.

Checklist to qualify S corporation shareholder for self employed health insurance deduction	
S corporation paid or reimbursed health insurance premiums	√
Health insurance premiums paid or reimbursed by the S corporation are added to the W-2 of the shareholder-employee.	√
Health insurance premium payments or reimbursements included in the shareholder-employee's W-2 are deducted on line 29 of the shareholder's Form 1040 as self employed health insurance.	√

No Problems for C Corporations

C corporations can deduct 100% of the health insurance and medical reimbursement for all employees (including shareholder/employees) "above-the-line" (§105(b) & §106), with the additional benefit that such reimbursement is "tax-free" to the employee (§1.162-10(a)).

Deducting Spouse's Health Insurance and Medical Reimbursement on Schedule C (ISP, effective 3/29/99; Rev. Rul. 71-588; LTR 9409006)

Potential tax-saving scheme: Hire spouse and deduct 100% of employer-provided health coverage with no W-2 income to spouse! Sole proprietors (and single member LLC owners) who hire their spouse as an employee may be allowed to deduct 100% of the cost of the spouse's accident and health coverage, including medical expense reimbursements, as a business expense. The employee-spouse must be a ***bona fide employee*** of the business or otherwise provide services to the business for which the accident and health coverage is ***reasonable compensation***. The cost of the health-related benefits are excludable from the employee spouse's income under §105(b) and §106 as tax-free fringe benefits.

> **Comment.** Remember hiring a spouse in your Schedule C business moves the deduction for health insurance from the front page of the Form 1040 to the Schedule C, reducing SE tax. More important, hire your spouse and establish a §105(b) plan to reimburse the medical expenses NOT paid for by insurance and you reduce income tax and SE tax!

Do we need to adopt a written agreement and plan document? Not for the payment of the §106 health insurance premium. But if the §105(b) self-insured medical expense reimbursement plan is also adopted, the IRS states that the business should be able to show that the employee-spouse is eligible to participate, including satisfying any waiting periods, etc.

> **Warning**. Employees, including spouses, cannot receive tax-free reimbursements under a medical expense reimbursement plan for expenses incurred before the plan is adopted. The IRS cites as their authority for this position *American Family Mutual Insurance Company*, 93-1 USTC ¶50025 and Rev. Rul. 71-403.

If spouse is covered, do all other employees also have to be covered? If the service requirement has not been consistently applied to all employees, the medical expense reimbursement plan is discriminatory under §105(h). The health insurance discrimination rules in §106 are more liberal.

Bona fide employee requirement. Whether the "employee-spouse" is a bona fide employee is determined on a case-by-case basis, using the common law rules (see Rev. Rul 87-41 and IRS's training manual 3320-102 (Revised 10-96), "Independent Contractor or Employee?"). The extent and nature of the spouse's involvement in the business operations is critical. A part-time worker may still qualify as a bona fide employee, although the performance of nominal or insignificant services that have no economic substance or independent significance may be challenged.

Be careful, the spouse must be an employee - not an owner! The IRS brings up a most interesting and potentially confusing argument by stating that the spouse may actually be a self-employed individual engaged in the trade or business as a joint owner, co-owner, or partner. "For example, a significant investment of the spouse's separate funds in (or significant co-ownership or joint ownership of) the business assets may support a finding that the spouse is self-employed in the business rather than an employee" (ISP, 3/29/99).

Reasonable compensation requirement. The total of any cash wages, plus the value of any tax-free medical benefits must be "reasonable compensation." The following factors are considered in determining the reasonableness of compensation:

1. Employee's role in the company
2. External comparison with other companies
3. Character and condition of the company
4. Internal consistency in compensation
5. Potential conflicts of interest/hypothetical independent investor (*Elliotts, Inc. v. Commissioner* (83-2 USTC ¶9610), 716 F.2d 1241 (9th Cir. 1983))

Partners and Spouses of Partners Can Use This Rule (LTR 200704017)

Partners (including LLC members) who hire their spouses are treated the same as sole proprietors, i.e., employees who are also spouses of partners/members may be provided tax-free health benefits, as long as the spouses themselves are not also partners/members (see Rev. Rul. 88-76).

Tax Court Found Insufficient Evidence That Farmer's Wife Was a Bona Fide Employee (*Milo L. And Sharlyn K. Shellito v. Comm.*, TCM 2010-41

Kansas farmer starts AgriPlan. Milo Shellito, a Kansas farmer since 1978, was joined by his wife, Sharlyn, in the farming activity in 1982. Prior to 2001, Sharlyn received no compensation for her work, which included assisting with the planting and harvesting of crops, operating tractors and equipment, feeding and caring for cattle, building and repairing fencing, maintaining and performing basic equipment repairs, running various errands, and performing accounting and bookkeeping services.

We have an employment agreement and a medical reimbursement plan. In 2001, Milo's CPA advised him to start treating Sharlyn as an employee and to set up §105 medical reimbursement plan. The CPA assisted Milo with the appropriate documentation, including filling out a preprinted application for an AgriPlan/BIZPLAN medical expense reimbursement plan, which offered medical expense reimbursements to Sharlyn, the only eligible employee. The available benefits for Sharlyn consisted of unlimited reimbursement of health insurance premiums for she and her family (including Milo and two dependent children) and reimbursement of up to $15,000 of out-of-pocket medical expenses.

We have a W-2 issued to wife and an audit trail showing the farmer paying spouse a monthly wage and reimbursing spouse for the medical expenses paid separately by her. On May 29, 2001, an individual checking account was opened in Sharlyn's name. Acting on the CPA's advice, on June 7, 2001, and each month thereafter in 2001 and 2002, Milo wrote Sharlyn a $100 check from their joint checking account, which she deposited into her individual checking account. The memo line on most of the checks and each accompanying deposit ticket stated that the check represented wages or salary. Sharlyn used these funds to pay for medical care for herself, Milo, and their two dependent children. Milo issued Sharlyn Form W-2s of $754 and $1,292 for 2001 and 2002, respectively. Milo also paid Sharlyn non-taxable medical expenses of $15,593 in 2001 and $20,897 in 2002. All medical expenses were properly reported to Agriplan/BIZPLAN, who prepared year-end reports for Milo.

But do we have a bona fide employee arrangement? The court concluded that Milo was not entitled to these deductions because Sharilyn was not a bona fide employee of her husband. The first sentence in the court's opinion goes to the heart of what the court perceived to be the problem: "Before 2001 [Sharlyn] had worked on [Milo's] family farm without compensation for about 20 years." In a most novel argument, with purported supporting citations, the court ruled that the existence of remuneration is an "essential condition" of an employer-employee relationship and absent remuneration, there is no "plausible" employment

relationship and consequently no need to undertake a common law agency analysis. The court also noted that "inferences might be drawn from [the Shellitos] describing, on their Forms 1040 for each year at issue, [Sharlyn's] occupation as "HOUSE WIFE"- a characterization that we believe was accurate."

- Also see: *Leo and Shawn M. Stephens v. Comm.*, TCS 2008-18 where payments made from a joint checking account were not considered reimbursements
- *Darwin J. Albers,* TC Memo 2007-144, no actual reimbursement was ever made. But, the IRS doesn't win them all
- *Ralph E. & Erika C. Frahm v. Comm.*, TCM 2007-351
- *Peter & Maureen Speltz v. Comm.*, TCS 2006-25

Checklist for Family Employee Benefit Programs

As previously discussed, business owners employing and providing benefits to family members will receive a great deal of scrutiny in the event of an audit. Of greatest concern is the legitimacy of the employer-employee relationship. Below is a checklist of factors that should be considered. While no one (or group of) item(s) is controlling, these are the types of factors that the IRS will investigate.

Factors to Consider	**Yes**	**No**
Is the compensation paid to the family member:		
1. Reasonable, e.g., valued at fair market?		
2. Evidenced by a written check, e.g., properly documented?		
3. For medical expenses deducted in the year reimbursed by the business?		
4. Redeposited into the business checking account?		
Is there documentation of the benefit plan, such as:		
1. Written employee benefit plan?		
2. Employee time records?		
3. Employment contract? Job description?		
4. Filed employment tax returns (941s, W-2s, etc)?		
5. Having the medical insurance plan in the name of (and are premiums paid by) the business or employee (not the proprietor/owner)?		
6. Adherence to nondiscrimination rules for non-family employees?		

Other items:		
1. Is money paid by employee spouse for medical expenses?		
2. Is money paid to employee spouse as a reimbursement or does business pay expenses directly?		
3. Is insurance in employee spouse's name?		

BUSINESS GENERAL ITEMS

PROVIDING FRAUDULENT FORM 1099

§7434 - **Civil Damages for Fraudulent Filing of Information Returns**

Every person engaged in a trade or business, including a partnership and a nonprofit organization, must file information returns with the IRS for each calendar year for certain payments made during the year (see §6041— §6050W). In addition, recipients must be furnished a copy of the information return or a comparable statement. But, if any person willfully files a fraudulent information return with respect to payments purported to have been made to another person, the other person may bring a civil action for damages against the person filing that return. A copy of the complaint initiating the action must be provided to the IRS. Recoverable damages are the greater of (1) $5,000 or (2) the amount of actual damages (including the costs of the action) and, in the court's discretion, reasonable attorney's fees (§7434)

For this purpose, the term "information return" includes (see §6724(d)(1)(A)):

- payments of $600 or more of rents, salaries and other business payments by persons engaged in (or considered to be engaged in) a trade or business and collections of foreign interest and dividends;
- direct sellers of consumer goods;
- taxable mergers or acquisitions;
- payments of dividends;
- payments of patronage dividends;
- payments by brokers;
- returns relating to actions affecting basis of specified securities;
- payments of interest;
- fishing boat operators;
- ***cancellation of indebtedness by financial institutions or other organizations for which a significant trade or business is the lending of money***;
- mortgage interest received in a trade or business from individuals;
- mortgage insurance premiums aggregating $600 or more received in the course of a trade or business from any individual starting in 2007;
- cash received in a trade or business;
- cash received by a court clerk as bail;
- foreclosures and abandonments of security;
- exchanges of partnership interests;
- transferors and transferees in certain asset acquisitions;

- dispositions of donated property;
- payments of royalties;
- income tax withheld on wage payments;
- payment of wages in the form of group-term life insurance;
- reportable acquisitions regarding applicable exempt organizations and applicable insurance contracts;
- large food and beverage establishments;
- provision of long-term care benefits;
- payments of $600 or more for purchases of fish by those engaged in the trade or business of buying fish for resale;
- payments for qualified tuition and related expenses or deductible student loan interest on qualified loans;
- health coverage tax credit advance payments;
- certain fuel oil information reporting;
- certain information reporting regarding a §38(h)(10) election;
- certain charges made for long-term care insurance under combined arrangements;
- information reporting in connection with certain options;
- any report required by the IRS for qualified lessee construction allowances;
- reports by the issuer or policyholder of a life insurance or endowment annuity contract on the unborrowed cash surrender value of the contract;
- information returns by employers or plan administrators100 or information returns for IRAs or individual retirement annuities;
- payments from which tax was required to be deducted and withheld under the withholding rules for nonresident aliens and foreign corporations or payments from which tax would have been required to be deducted and withheld but for an exemption under the Code or any U.S. treaty;
- payments made in settlement of payment card and third party network transactions;
- provision of essential minimum health care coverage to another; or
- employer provided health insurance coverage.

Just Because a Form 1099-C is Voluntarily Sent Does Not Mean the Sender Can Be Sued for Sending a Fraudulent Form 1099 (*Robert F. Cavoto v. Mary Lou Hayes*, (CA-7), 2011-1 USTC ¶50,257, 10-2681, February 28, 2011)

Ex-mother-in-law voluntarily sent ex-son-in-law a $30,000 Form 1099-C and took a non-business bad debt deduction. Robert Cavoto and his then-wife, Susan, were in financial trouble. To help them out, Mary Lou, Susan's mother, allowed the Cavotos to rack up over $30,000 on her American Express credit card. The Cavotos then separated and eventually divorced. After the separation, Robert e-mailed Mary Lou that he anticipated receiving more than $30,000 from receivables due his recruitment and consulting firm, and said he would use those funds to repay her. Payment never came. Mary Lou cancelled the credit card, paid the balance due and unsuccessfully tried to recoup her $30,000 from Robert. After receiving advice from her other daughter, a CPA, Mary Lou took a nonbusiness bad-debt deduction ***and*** filed a Form 1099-C with the IRS reporting that she had discharged the $30,000 debt.

> **Note**. Financial institutions are the only one *required* to file the discharge of debt of $600 or more.

In response, ex-son-in-law sues ex-mother-in-law for filing a "fraudulent return" with IRS; in counter-response, ex-Mom sues for the unpaid loan. Of course, the IRS sent Robert an $11,000 deficiency notice. Robert filed an objection with the IRS and then, two months later, sued Mary Lou under §7434 for filing a

fraudulent "information return." Interestingly, after Robert filed suit, the IRS notified him that it would ***not*** pursue collection of any additional income or penalties. Not happy, Robert still sued Mary Lou for his attorney's fees and other expenses ***and*** the $5,000 §7434 fraudulent filing penalty.

Voluntarily filing a Form 1099-C isn't the same as filing a fraudulent information return. Ex-mother-in-law wins. Robert argued that, because only financial entities and not individuals are required to file a Form 1099-C, Mary Lou must have acted with fraudulent intent because her only possible motive was to cause him to incur additional taxable income. He also asserted that Mary Lou's filing was also fraudulent because he did not owe her anything. Mary Lou counterclaimed for the $30,000, claiming breach of a loan contract. The court determined that Robert's position was incorrect because Form 1099-C, false or not, isn't one of the nine forms under the false form remedy (see §7434(f); §6724(d)(1)(A)).

The Court of Appeals pointed out that the remedy created by §7434 is limited in scope to only forms for:

- certain information at source (see §6724(d)(1)(A)(i));
- payments of dividends (§6724(d)(1)(A)(ii));
- payments of patronage dividends (§6724(d)(1)(A)(iii));
- payments of interest (§6724(d)(1)(A)(iv));
- reporting requirements of certain fishing boat operators (§6724(d)(1)(A)(v));
- payments of royalties (§6724(d)(1)(A)(vi));
- information returns with respect to income tax withheld (§6724(d)(1)(A)(vii));
- returns relating to certain purchases of fish (§6724(d)(1)(A)(viii));
- qualified lessee construction allowances for short-term leases (§6724(d)(1)(A)(ix));

Those nine do not include returns relating to the cancellation of indebtedness, i.e., a Form 1099-C.

Ex son-in-law loses a second time; Ex-mother-in-law owed $30,000. Interestingly, the district court, with the Court of Appeals concurring, found that since Robert agreed to reimburse Mary Lou, she had a good-faith belief that when she filed the Form 1099-C she was cancelling a bona fide debt, and this meant that the Form 1099-C was not fraudulent. Better yet, the district court also found that Mary Lou showed that Robert had breached the contract by failing to repay her, and thus found for her on this claim as well. The Court of Appeals felt that Robert inappropriately slung insults at the district judge and Mary Lou in his brief, and, not surprisingly, could find no reason why the court should believe Robert's version over Mary Lou's.

Three strikes, you're out, ex-son-in-law! Last, Robert asked the Court of Appeals to reverse the district court because, he said, his lawyer was ineffective. The Court found this argument frivolous. A retrial is not a proper remedy for deficient representation in a civil action.

§162/§183 - When Does a Consulting Practice Not Rise to the Level of a Trade or Business (*Estate of Roger E. Stangeland and Lilah M. Stangeland v. Comm*. TCM 2010-185)?

Problem with owning multiple independent businesses managed through a Schedule C, but not charging for services rendered. The deceased[17] taxpayer, Roger Stangeland, along with his wife, children and other third parties, were the owners of numerous businesses in six states, including the Vons grocery chain, shopping centers, hotels/motels, a warehouse, and multiple other enterprises. Each business had

[17] He died in 2004 of heart failure at age 74.

separate management groups. To help manage all these businesses, Roger worked approximately 50 hours per week providing “consulting services,” which he reported on a Schedule C named ResEnt. The problem was Roger reported no income on the Schedule C, but did report substantial expenses, including office rent, supplies, wages, travel (on his Gulf Stream G-111), accounting, consulting, and legal fees.

> **Comment.** The IRS deficiency notice totaled $1.35 million for the three years at issue, which, interestingly, were the three years prior to his death!

The IRS conceded that Roger provided substantial services to his businesses. But, none of the businesses ever reimbursed Roger for his services.

Managing multiple businesses vs. managing multiple investments. The IRS determined that Roger could not deduct the expenses on the ResEnt Schedule C, arguing that it wasn’t a trade or business because Roger did not engage in consulting services for income or profit. Roger disagreed, arguing that he was engaged in ResEnt for income or profit because ResEnt's consulting increased the profitability of Roger’s other businesses. However, the IRS countered that Roger was managing his multiple investments, and the Supreme Court has long held that activity geared towards increasing the value of investments is not a trade or business (*Whipple v. Comm.*, 373 U.S. 193, 202-203 (1963)). “When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.” The Tax Court determined ResEnt provided consulting for the general purpose of increasing the value of Roger’s other businesses. Therefore Roger was not conducting a trade or business; he was merely monitoring his investments.

> **Comment.** Interestingly, Roger did not argue that ResEnt's expenses were miscellaneous itemized deductions, probably because, after the 2% AGI haircut or AMT, the characterization would have been of limited use.

Is a Schedule C managing multiple businesses one business activity under §183? After losing the argument that his consulting practice was a business, and not a investment, Roger argued that under §183 the ResEnt undertaking was part of an activity that encompasses all of his other businesses, and that his profit motive in the ResEnt undertaking must be viewed from that perspective. Could the consulting business be merged with his other businesses?

Multiple undertakings of a taxpayer may be treated as one activity only if the undertakings are sufficiently interconnected. The most important factors in making this determination are the degree of organizational and economic interrelationship of the undertakings, the business purpose served by carrying on the undertakings separately or together, and the similarity of the undertakings. Generally, the IRS will accept the taxpayer's characterization of two or more undertakings as one activity unless the characterization is artificial or unreasonable (§1.183-1(d)(1)). Factors the courts have used to determine whether the taxpayer's characterization is unreasonable include:

1. Whether the undertakings are conducted at the same place
2. Whether the undertakings were part of the taxpayer's efforts to find sources of revenue from his or her land
3. Whether the undertakings were formed as separate activities
4. Whether one undertaking benefitted from the other

5. Whether the taxpayer used one undertaking to advertise the other
6. The degree to which the undertakings shared management
7. The degree to which one caretaker oversaw the assets of both undertakings
8. Whether the taxpayer used the same accountant for the undertakings
9. The degree to which the undertakings shared books and records [see: *Mitchell v. Comm.,* T.C. Memo. 2006-145 (citing *Keanini v. Comm.,* 94 T.C. 41, 46, (1990)); *Tobin v. Comm.,* T.C. Memo. 1999-328; *Estate of Brockenbrough v. Comm.*, T.C. Memo. 1998-454; *Hoyle v. Comm.,* T.C. Memo. 1994-592

The Tax Court ruled that Roger's businesses could not be viewed as one activity under §183 because although Roger was involved in all of his businesses, the businesses had different management structures. Roger argued that the businesses all drew on his knowledge of retail sales, but the businesses fail almost all the commonly used factors for combining businesses.

You made your bed, now sleep in it. Given that Roger was free to choose the structure of ResEnt, the court viewed with suspicion Roger's attempt to convince the court that the separate structures of ResEnt and the businesses should be disregarded. The court stated that taxpayers "may arrange their affairs to make a profit in a particular corporation, – see *Campbell v. Comm.*, 868 F.2d at 836) but they may not create structures with separate offices, separate management, separate owners, separate books, and separate undertakings and then later claim that the structures they created are really one activity under §183."

> **Planning point.** Roger could have solved this problem by forming a management entity and have each of his businesses pay fees for services rendered into this entity. Roger needed income to offset his expenses. Alternatively, he could have had each business pay a portion of his costs under an accountable reimbursement plan.

Taxpayers Who "Flip" Properties Must Report Gains on Schedule C (*Wendell Garrison v. Comm.*, TCM 2010-261)

During tax years 1998 through 2000, Wendell and Sharon Garrison regularly purchased and sold real estate within short periods. Mr. Garrison earned not more than $40,000 annually as a mortgage banker, and the Garrisons' purchases and sales of real estate contributed substantially to their income.

In 1998 the Garrisons sold eight parcels of real property. They sold all those properties within two months of purchase, with one exception. In 1999 and 2000 the Garrisons sold four parcels of real property each year. The Garrisons sold each property within 10 weeks of acquiring it. Over the three years, the Garrisons did not rent any of the properties before selling them.

Capital gain v. ordinary income. The Court agreed with the IRS that the real estate the Garrisons purchased and sold was held primarily for sale to customers in the ordinary course of the Garrisons' trade or business of real estate refurbishment and not for investment. The Court consider the frequency, continuity, and substantiality of the Garrisons' property sales (see *Bruce Rice v. Comm*., TCM 2009-142). The Garrisons engaged in at least 15 sales over three years, and most of the sales occurred within four months after they purchased the property. Income should have been reported on Schedule C, not on Form 4797.

Self employment tax applies. The Garrisons were engaged in the trade or business of purchasing and selling real property. Therefore, they were also subject to self employment tax.

Food Inventory Contributions (Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312))

Extension of enhanced charitable deduction for contributions of food inventory. The 2010 Tax Relief Act extended for two years (through 2011) the provision allowing businesses to claim an enhanced deduction for the contribution of food inventory.

Miscellaneous Extender Business Provisions (Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312))

Election to expense advanced mine safety equipment. The 2010 Tax Relief Act extends for two years (through 2010) the provision that provides businesses with 50% bonus depreciation for certain qualified underground mine safety equipment.

Extension of special expensing rules for U.S. film and television productions. The 2010 Tax Relief Act extends for two years (through 2011) the provision that allows film and television producers to expense the first $15 million of production costs incurred in the United States ($20 million if the costs are incurred in economically depressed areas in the United States).

Extension of expensing of environmental remediation costs. The 2010 Tax Relief Act extends for two years (through 2011) the provision that allows for the expensing of costs associated with cleaning up hazardous sites.

Extension of special tax treatment of certain payments to controlling exempt organizations. The 2010 Tax Relief Act extends for two years (through 2011) the special rules for interest, rents, royalties and annuities received by a tax exempt entity from a controlled entity.

Treatment of certain dividends of Regulated Investment Companies (RICs). The 2010 Tax Relief Act extends a provision allowing a RIC, under certain circumstances, to designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. In addition, an interest-related dividend received by a foreign person generally is exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442 of the Code. The 2010 Tax Relief Act extends the treatment of interest-related dividends and short-term capital gain dividends received by a RIC to taxable years of the RIC beginning before January 1, 2012.

Treatment of RIC investments as "Qualified Investment Entities" under FIRPTA. The 2010 Tax Relief Act extends the inclusion of a RIC within the definition of a "qualified investment entity" under §897 of the Tax Code through December 31, 2011.

Active financing exception. The 2010 Tax Relief Act extends for two years (through 2011) the active financing exception from Subpart F of the tax code.

Empowerment Zones. The 2010 Tax Relief Act extends for two years (through 2011) the designation of certain economically depressed census tracts as Empowerment Zones. Businesses and individual residents within Empowerment Zones are eligible for special tax incentives.

District of Columbia Enterprise Zone. The 2010 Tax Relief Act extends for two years (through 2011) the designation of certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone. Businesses and individual residents within this enterprise zone are eligible for special tax incentives. The bill also extends for two years (through 2011) the $5,000 first-time homebuyer credit for the District of Columbia.

ACTIVITIES NOT ENGAGED IN FOR PROFIT (HOBBY LOSSES) §183

"In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed (§183(a))."

Hobby Loss Rules (§183: Activities Not Engaged in for Profit (ATG)

Must be engaged in for profit. Taxpayers are generally allowed to deduct expenses which are incurred in a trade or business (§162) or for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income (§212). For the expenses to be deductible under §162 or §212, taxpayers must engage in or carry on an activity to which the expenses relate with an ***actual and honest objective of making a profit*** (*Samuel Keanini v. Comm*., USTC No. 46,354, 94 TC 41 (Jan. 30, 1990); *Maurice C, Dreicer v. Comm*., USTC No. 38,948, 78 TC 642 (Apr. 19, 1982)). Taxpayers bear the burden of proving that they are engaged in the activity with an actual and honest objective of realizing a profit and must devote time to the business in the honest belief that the business will sometime in the future become profitable.

If no profit motive, hobby loss rules restrict deductions (§183(b)). When taxpayers are engaged in an activity with an ***actual and honest objective of making a profit***, expenses incurred in a §162 trade or business or a §212 activity for the production of income are deductible. But, if no profit motive exists, the §183(b) hobby loss rules allow only those deductions to the extent of gross income unless the deductions would have been allowed anyway (for example, mortgage interest and property taxes deductible on Schedule A). Gross income under §183 includes the total of all gains from the sale, exchange or other disposition of property and all other gross receipts derived from such activity (§1.183-1(e)).

Deductions for hobby activities are claimed as itemized deductions on Schedule A (Form 1040). Hobby loss deductions must be taken in the following order and only to the extent stated in each of three categories:

1. First, 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.
2. Next, deductions that don't result in an adjustment to basis, such as advertising, insurance premiums and wages, may be taken to the extent gross income for the activity is more than the deductions from the first category.
3. Lastly, deductions that reduce the basis of business property, such as depreciation and amortization, are taken, but only to the extent gross income for the activity is more than the deductions taken in the first two categories.

   Note. Activities conducted in S corporations and partnerships are subject to the §183 loss limitations, but not activities conducted in C corporations.

IRS factors used to determine profit motive. Whether or not an activity is presumed to be operated for profit requires an analysis of the facts and circumstances of each case. Neither the Code nor the Regulations provide an absolute definition. As a result, deciding whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine nonexclusive factors contained in §1.183-2(b). These factors are:

- The manner in which the taxpayer carried on the activity
- The expertise of the taxpayer or his or her advisers
- The time and effort expended by the taxpayer in carrying on the activity
- The expectation that the assets used in the activity may appreciate in value
- The success of the taxpayer in carrying on other similar or dissimilar activities
- 73The taxpayer's history of income or loss with respect to the activity
- The amount of occasional profits, if any, which are earned
- The financial status of the taxpayer
- Elements of personal pleasure or recreation

No single factor controls; other factors may be considered; and the mere fact that the number of factors indicating the lack of a profit objective exceeds the number indicating the presence of a profit objective (or vice versa) is not conclusive. For example, if five factors say the activity is not for profit, but four are on the profit side, the activity still could be determined to be engaged in for profit.

The "presumption" tests (§183(d)). The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year (two of the last seven years for activities that consist primarily of breeding, showing, training or racing horses).

Loser: Bass Fisherman Skunked in Tax Court (*Steve L. And Janice M. Lowe v. Comm.*, TCM 2010-129

Steve Lowe began bass fishing professionally in 2003, after spending many years as a recreational fisherman. Steve had no other job, but, fortunately for him, his wife, Janice, worked full time as a controller for a local business. In 2005 and 2006, Steve fished in 26 tournaments ($4,241 gross income) and 15 tournaments ($10,932 gross income) respectively. For most tournaments, entry fees ranged from $280 to $825; however, certain tournaments required an additional $325 for a co-angler. In such cases, Steve listed Janice as his co-angler even though she did not actually compete. Tournament competitors vied for first-place prizes of $4,000 to $50,000. If Steve or any other competitor accumulated sufficient points during the year, he could have qualified to compete in a year end national fish-off tournament for which first place would pay $250,000.

IRS reviews numbers and smells something fishy! On his 2003 through 2006 Sch. Cs, Steve listed his principal profession as "professional fishing." From 2003 to 2006, he and Janice reported the following amounts on their Federal income tax returns:

Year	W-2 Wage Income	Fishing Activity Gross	Fishing Activity Expenses	Net Sch. C Profit (Loss)	Taxable Income
2003	$166,366	$420	$33,007	($32,587)	$100,936
2004	$168,966	$2,550	$34,865	($32,315)	$103,713

2005	$177,219	$4,241	$49,067	($44,826)	$63,114
2006	$184,181	$10,932	$48,608	($37,676)	$146,484

Decision is based on the hobby factors:

1. **Manner in which the taxpayer carries on the activity.** At trial Steve admitted that he did not maintain a separate bank account or prepare any reports, forecasts, schedules, analyses, or other documents to assist his managing the activity. The court ruled this factor to be neutral.
2. **Expertise of the taxpayers or their advisers.** Steve proved that he studied bass fishing extensively and kept a substantial library of books, magazines, newspapers, and videos on the topic. Steve consulted professional fishermen to improve profitability. The court ruled this factor favored Steve.
3. **Time and effort expended.** Steve clearly devoted a substantial amount of time to the fishing activity, often as much as 60 hours per week. He treated the fishing activity as his job and he had no other income. The court ruled this factor favored Steve.
4. **Expectation that activity assets will appreciate.** Steve admitted at trial that none of his fishing equipment would increase in value. The court ruled this factor favored the IRS.
5. **Success of the taxpayer in carrying on other similar or dissimilar activities.** Steve had never carried on any other successful business. The court ruled this factor favored the IRS.
6. **History of income or losses.** In the years at issue, Steve claimed losses of $82,502 from an activity that had never been profitable. Steve, however, argued that the years at issue were well within the startup phase of his activity and the court agreed that five years was an acceptable startup period (see also: *Tommy W. and Pamela L. Busbee v. Comm.*, TCM 2000-182; *John R. and Kathleen M. Zwicky v. Comm.*, TCM 1984-471). The court ruled this factor neutral.
7. **Amount of occasional profits.** The court noted that the fishing activity had yet to reel in any profits and, while it was not necessary for Steve to prove that his profit objective was reasonable, the objective must be to make a profit. The court noted that Steve's winnings were never close to covering his entry fees, let alone all his other expenses and ruled this factor favored the IRS.
8. **Taxpayer's financial status.** Janice Lowe earned substantial income from her job and Steve's losses from his fishing activity resulted in substantial tax benefits. The Lowes were able to deduct losses averaging about $41,000 per year. The court ruled this factor favored the IRS.
9. **Elements of personal pleasure.** Steve credibly testified that fishing used to be fun when he was fishing recreationally, but competitive fishing was not fun and the court ruled this factor neutral.

Tax court creates its own 10th test: – asking spouse to tag along means no profit motive. The court further noted that Steve's competitive strategy was not fully consistent with an intent to make a profit. On several occasions, Janice entered tournaments as Steve's fishing partner, even though she didn't fish. While this allowed Steve and Janice to spend a day together in the outdoors, it also doubled Steve's entry fees and boat costs. The court ruled that this was a clear indication that Steve did not have the requisite profit motive and he loses.

Amway Distributorship Rules a Hobby — Again (Roger S. and Lisa G. Campbell v. Comm., TCM 2011-42)

The IRS has successfully denied a Schedule C loss to an Amway distributors on the grounds it was a hobby because Roger and Lisa Campbell:

- Only determined if the Amway Distributorship was profitable after the year-end and for tax purposes,
- Deducted personal expenses as Amway business expenses,
- Commingled costs of Amway products used for personal purposes, resulting in a substantial misstatement of their cost of goods sold and profits,
- Seemed to be largely indifferent to whether the Amway activity, standing alone, produced a profit,
- Seemed to accept the losses as they offset profits from Lisa's real estate business and Roger's construction company, and
- Padded the Amway income for sales to their other businesses and for their personal use.

See also:

- *Linda K. Betts v. Comm.*, TCM 2010-164, taxpayer got away with deducting horse ranch 1990s, tried again in 2000s and court said no.
- *Lee Edward Elverson v. Comm.*, TCS 2010-36, Pennsylvania taxpayer operated accounting business profitable in only one of ten years – court says it's a hobby.
- *Colleen A. Lynch v. Comm.*, TCS 2010-95, intent of selling jewelry part-time was to make a profit.
- *Shawn Colleen and David Blanchette, TCS 2011-15*, losses from the sale of science fiction memorabilia were disallowed for lack of business like conduct. Mrs. Blanchette did not dispose of worthless memorabilia, did not insure her collection, did not prepare financial analysis or income statements.

DEPRECIATION/MACRS §167, §168 & §179

§179 Provides An Option to the Slower Depreciation Deduction (Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312), superceding the Hiring Incentives to Restore Employment Act of 2010; Rev. Proc. 2010-24)

§179 Chart	2008-2009	**2010-2011**	2012
Maximum §179 Deduction	$250,000	**$500,000**	$25,000
Maximum Annual Qualifying Property Before Phase-out	$800,000	**$2,000,000**	$200,000

The Small Business Jobs Act of 2010 increased and extended §179. A taxpayer may elect to deduct the cost of certain qualified business property placed in service for the year rather than depreciate those costs over time. The 2003 tax cuts temporarily increased the maximum dollar amount that may be deducted from $25,000 to $100,000. These amounts have been further increased and extended several times on a temporary basis, including most recently as part of the Small Business Jobs Act which increased the thresholds to $500,000 and $2,000,000 for the taxable years beginning in 2010 and 2011. The 2010 Tax Relief Act extends the maximum amount and phase-out thresholds for taxable years beginning in 2012, at $125,000 and $500,000 respectively, indexed for inflation. The 2010 Tax Relief Act is effective for taxable years beginning after December 31, 2011.

Maximum annual qualifying property increased to $2 million. §179 expensing has always been aimed at the small business but the change of the phaseout amount from $800,000 to $2,000,000 shifts the expensing benefit to the mid-size business.

Example. Sharon and Karen own an imaging lab in Palo Alto. Their MRI machine is several years old. They would like to replace it with more modern technology but have hesitated to spend the money in a recession. Because of the change to §179, they will purchase a new $1.5 million MRI before year end. Their write off for the new machine will be $500,000 §179 plus $500,000 bonus depreciation plus mid-quarter depreciation on the balance. If they purchased the MRI in 2009, they would not have qualified for §179.

Taxable income limitation. The §179 deduction is limited to the taxpayer's taxable income computed without taking into account any deduction for self-employment taxes, net operating loss carryback or carryover, §179 expensing, or deductions suspended under any provision (§179(b)(3); §1.179-2(c)(1)). Any amount limited by this provision may be carried forward and deducted in subsequent tax years, subject to the maximum dollar and investment limitations, or, if lower, the taxable income limitation in effect for the carryover year (§179(b)(3)(B)).

How much is too much? Congress believes that this increase to the expensing election will encourage small businesses to buy expensive equipment. Two problems exist.

1. Since the §179 deduction is limited to the taxable income of the business, the small business needs $500,000 of profit sitting around to enjoy the full benefit of this increase. How many of your small business clients used the full $250,000 amount last year? Will the increase to $500,000 inspire them to spend?
2. Most businesses pay for large equipment purchases over time. Section 179 allows the deduction ahead of the profits used to pay for the equipment. The deduction won't match cash flow and that means that the small business might find itself in a few years with taxable income and no cash to pay the tax.

Definition of §179 Property Expands to Include Real Estate (§179(f))

SBJA expanded the definition of §179 qualifying property to include qualified leasehold improvement property,[18] qualified restaurant property,[19] and qualified retail improvement property.[20] Prior to 2010, these definitions were used to define qualified real property eligible for 15-year depreciable lives. This provision is effective for tax years beginning in 2010 and 2011. The maximum amount of §179 expense that may be elected for real property assets is annually limited to $250,000, not $500,000.

Beware the limitations for 2011. Additionally, §179 deductions attributable to qualified real property that are disallowed due to the trade or business income limitation may be carried over only to taxable years in which the definition of eligible §179 property includes qualified real property. Any such amounts not used in 2011 are treated as property placed in service in 2011 for purposes of computing depreciation. Amounts carried forward from 2010 are considered placed in service on the first day of the 2011 taxable year.

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[18] As defined in §168(e)(6)

[19] As defined in §168(e)(7)

[20] As defined in §168(e)(8)

Example. Melissa made improvements to her restaurant building totaling $124,000 in 2010 and elected to claim §179 expense deduction for the entire amount. Melissa's 2010 restaurant income, without regard to the §179 expense, was only $40,000, requiring her to carry $84,000 of §179 expense forward to 2011. Melissa's 2011 restaurant income before deducting any §179 expense was $60,000. She did not purchase any §179 qualified assets in 2011. On her 2011 return, Melissa will deduct $60,000 of the 2010 carryover of §179 expense. The $24,000 remaining §179 carry over will actually be treated as an asset placed in service Jan. 1, 2011. Melissa's 2011 §179 expense deduction and profit are calculated:

Profit prior to §179 or related depreciation	$60,000
§179 expense deduction	(60,000)
Sub-total	- 0 -
Depreciation on left over §179 assets (2.461% of $24,000)	(591)
2011 net profit (loss)	(591)

Note. The excess §179 actually becomes a depreciable asset.

Section 179 is recaptured as ordinary income at sale! Any §179 expense deduction that is later recaptured on sale of real property will be taxed as ordinary income (§1245(a)(2)).

Should the client take the §179 anyway and give up the lower capital gains rates at sale? Here are a few considerations:

1. A deduction today and a pay back several years from now still gives the client a measurable present value calculation.
2. The tenant who pays for, or shares in the payment of, his leasehold improvements will have no gain when he abandons his lease. He didn't sell anything.
3. The landlord who pays for tenant improvements may tear them out when her tenant vacates to make the property more rentable. She has no gain on sale; she didn't sell.
4. The landlord who pays for tenant improvements and later sells the property would have recapture at ordinary rates if he actually paid taxes at the sale. But, don't many property owners exchange their properties onto others? The recapture just may be deferred forever if the client continues to exchange.

§179 cannot create or increase a loss. The expensing election is limited to the amount of taxable income from all of the taxpayer's active trades or businesses. Taxable income is computed without the §179 deduction, without any net operating loss carrybacks or carryforwards, and without deducting one-half of self-employment (§1.179-2(c)(1)). The net income, and losses, from all actively conducted businesses of the taxpayer (i.e., all Schedules C's, F's and K-1's) are aggregated for purposes of this income limitation (§1.179-2(c)(1)). The "net income definition" includes a partner's share of income from a partnership (or shareholder's share of income from an S corporation) as long as the partner/shareholder is active (§1.179-2(c)(2); -2(c)(6)(ii)). Also aggregated are §1231 gains (or losses) from the sale of business assets, and interest income from working capital (§1.179-2(c)(1)). §179 deductions that are disallowed because of the income limitation may be carried forward indefinitely, subject to the annual limitations for total §179 expense and for maximum assets purchases (§1.179-3(a)). The taxpayer may choose the properties for which the cost will be carried forward, as well as the portion of each property's cost to be carried forward.

Preparer Point. A taxpayer can include wages and salaries of the taxpayer (and spouse), even if the earned wages are not from the business deducting the §179 property (§1.179-2(c)(6)(iv)).

Preparer Point. Vehicles for which a §179 deduction has been claimed must maintain business use >50% or be subject to §179 recapture. Such recapture is reported on Form 4797 in the year that business use drops to 50% or below. The recapture amount is reported as other income on the schedule where the depreciation was originally taken (i.e., Sch. C). An amended return is not required (see *Michael Birdsill v. Comr.*, TCS 2008-55).

15-Year Depreciable Life for Real Estate Improvements.

The 2010 Tax Relief Act extends for two years (through 2011) the special 15-year cost recovery period for certain leasehold improvements, restaurant buildings and improvements, and retail improvements.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service.

Planning point. Qualified leasehold property qualifies for additional first year depreciation.

Qualified restaurant property is any §1250 property that is a building (if the building is placed in service after December 31, 2008 and before January 1, 2010) or an improvement to a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method and a half-year convention.

Planning point. Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Planning point. Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.

§179 and Bonus for Qualified Real Property	2010	2011	2012	2013
Qualified Leasehold Improvements				
$250,000 §179	yes	yes	n/a	n/a
bonus depreciation	yes	yes	no ①	n/a
depreciable life	15 years	15 years	39 years	39 years
Qualified Restaurant Property				
$250,000 §179	yes	yes	n/a	n/a
bonus depreciation	no②	no	no ①	n/a
depreciable life	15 years	15 years	39 years	39 years
Qualified Retail Improvement Property				
$250,000 §179	yes	yes	n/a	n/a
bonus depreciation	no ②	no	no	n/a
depreciable life	15 years	15 years	39 years	39 years
①May qualify for bonus if 15 year depreciable life extended ②§179 allowed only if also qualified leasehold property				

§168(k) Special Bonus Depreciation (Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312); ARRA 2009; Economic Stimulus Act of 2008).

Congress allowed businesses, beginning January 1, 2008 through December 31, 2009, to take an additional "bonus" depreciation deduction allowance equal to 50% of the cost of new business depreciable personal property placed in service in those years. Under the *Small Business Jobs Act of 2010*, this bonus depreciation deduction allowance was extended through December 31, 2010.

The 2010 Tax Relief Act modifies the acquisition date and temporarily increases the bonus depreciation percentage for investments in new business equipment. For investments placed in service after September 8, 2010 and through December 31, 2011, the bill provides for 100% bonus depreciation. For investments placed in service after December 31, 2011 and through December 31, 2012, the bill reduces the bonus depreciation to 50%. The new law also allows corporate taxpayers to elect to accelerate some AMT credits in lieu of bonus depreciation for taxable years 2011 and 2012.

Bonus Depreciation Chart	
effective date	deduction amount
Jan. 1, 2008 to Sep. 8, 2010	50%
Sep. 9, 2010 to Dec. 31, 2011	100%
Jan. 1, 2012 to Dec. 31, 2012	50%

Planning point. The purchase of new equipment will give the business client a 100% deduction for the cost. Does this sound like §179 expensing to you? Almost. Section 179 expensing is available for new and used equipment. But, §179 is limited to the taxable income of the business. 100% bonus depreciation is available only for new assets and the depreciation deduction can create a loss. That loss can result in a NOL carryback (or carry forward.)

Planning point. Bonus depreciation continues to be limited to $8,000 for a new luxury auto. Thus, the maximum depreciation for a new luxury auto purchased in 2011 is $11,060 ($8,000 + $3,060).

Planning point. Section 179 is limited to $25,000 for the purchase of an SUV weighing more than 6,000 pounds (GVW). There is no similar limit to bonus depreciation. So the purchase of a new SUV will qualify the taxpayer for a 100% write off (times the business percentage.)

Qualifying property. In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements:

1. The property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in §168(e)(5)), (3) computer software other than computer software covered by §197, or (4) qualified leasehold improvement property (as defined in §168(k)(3)).
2. The original use of the property must commence with the taxpayer after December 31, 2007.
3. The taxpayer must purchase the property within the applicable time period.
4. The property must be placed in service after December 31, 2007, and before January 1, 2013. An extension of the placed in service date to January 1, 2014 is provided for certain property with a recovery period of 10 years or longer and certain transportation property.

Related party rules apply. Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

Bonus depreciation allowed for luxury autos used for business. The limitation on the amount of depreciation deductions allowed for luxury automobiles (§280F) is increased in the first year by $8,000 for automobiles that qualify (and do not elect out of the increased first year deduction). The $8,000 increase is not indexed for inflation.

Form 4562-FY. To reflect the 50% special depreciation allowance, the IRS released a special version of the depreciation and amortization form for fiscal year filers, Form 4562-FY. Calendar year taxpayers continue to use Form 4562.

Comparing §179 and Bonus Depreciation		
	§179	**§168(k)**
New or used property	Both new or used	New, original use only
Placed in service	Taxable years beginning in -	Calendar year 2008 - 2012
Limited to taxable income	Yes	No
Eligible property	Generally, only personal property, but in 2010 and 2011 some real property improvements qualify	MACRS life of 20 years or less
Recapture for personal use	Yes, if business use drops to 50% or less	No
Types of activities	Active trade or business only	All activities (rentals)
Election can be modified	Yes, on amended return	No, binding w/o IRS permission
Deduction amount limited	$500,000 ($250,000 in 2008 - 2009)	No
Like-kind exchange basis	New boot only	100% of basis
Purchase amount limited	Yes, phaseout starts @ $2,000,000 ($800,000 in 2008 - 2009)	No, unlimited purchases

Planning point. A 100% deduction in the year of purchase (whether §179 or bonus depreciation) for equipment that is paid for over several years will create extra deductions above cash requirements in year one. When the loan payments are made in subsequent years, profits will be used to make non deductible payments. “Phantom” income will result.

Bonus Depreciation Change Creates a Few More Planning Opportunities

The 2010 Tax Relief Act amended §168(k) to allow for 100% additional first year depreciation for new qualifying property purchased after Sept. 8, 2010 and before Dec. 31, 2011. This sounds a lot like §179 expensing, doesn’t it?

SUV limits do not apply. §179 is limited to $25,000 for the purchase of a big SUV (over 6,000 GVW). Bonus depreciation is unlimited.

Example. Ron purchases a new Ford Suburban May 1, 2011 for $60,000. Ron can use bonus depreciation to deduct the entire purchase price of the SUV (times his business percentage, of course). He is not limited by §179's $25,000 amount.

Warning. Ron has a -0- basis when he is done and must be warned about recapture at sale. A §1031 exchange is advisable.

Bonus depreciation not limited by taxable income. §179 is limited to the taxable income of the business. Bonus depreciation is not. Thus, bonus depreciation can shelter the other taxable income of the client and perhaps create an NOL for carryback.

Preparer point. Be careful to enter the actual date of purchase and not simply "July 1, 2010." That short cut can hurt the client.

Planning point. Bonus depreciation generates an immediate tax deduction even if the payments to buy the equipment extend over several years. Remind the client that principle payments are not deductible. This means that the client will use taxable income to make non deductible loan payments. The deduction does not match cash flow.

Requirements Before Assets Can Be Depreciated (§167, §168, §197)

Only property that wears out can be depreciated! Any analysis of the propriety of a cost recovery deduction must take into account the type of property for which a taxpayer is claiming a cost recovery allowance deduction and whether the property is subject to wear and tear, decay or decline from natural causes, exhaustion, and/or obsolescence during the time that the property is used in the taxpayer's business (§167 [ACRS], §168 [MACRS], §197 [amortization], and related regulations). If property is not subject to wear and tear, to decay or decline from natural causes, to exhaustion, and/or to obsolescence, no allowance for depreciation is deductible (§1.167(a)-2). Personal property is only depreciable if the taxpayer established the useful life of the property(§1.167(a)-1(a) and (b)). For example, no depreciation is allowed with respect to museum pieces of indeterminable useful life (*Harrah's Club v. United States*, 228 Ct. Cl. 650, 661 F.2d 203 (1981)). In addition, a painting displayed for business purposes that suffers no wear and tear is not depreciable under ACRS when the taxpayer failed to prove a determinable useful life (*Clinger v. Comm*. T.C. Memo. 1990-459). Under ACRS, however, once the taxpayer establishes that an asset is subject to exhaustion, wear and tear, or obsolescence, the taxpayer does not need to show the useful life of the asset (*Liddle v. Comm.*, 103 TC 285 (1994), affd. 65 F.3d 329 (3d Cir. 1995); *Selig v. Comm*., T.C. Memo. 1995-519).

Personal assets nondepreciable. If property might otherwise be subject to the cost recovery provisions because the property is adversely affected by use or by the passage of time, generally no deduction for personal, living, or family expenses is allowed (§262(a)), and no depreciation deduction is allowed for personal use property (§1.167(a)-1(a)).

Depreciation of entertainment items restricted. No deduction otherwise allowable is permitted for any entertainment item "With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation" unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business (§274(a)(1)(A)).

Depreciation Deductions Denied on Collection of Memorabilia Related to Celebrities (*Darrell Rooney v. Comm.*, TCM 2011-14)

The facts. Darrell Rooney is a well-known film director, animator, writer, and producer who was employed during the year at issue, 2003, by Walt Disney Pictures & Television. For example, in the mid-1990s Walt Disney hired Darrell to direct the animated films "Mulan 2" (2004), "Lady and the Tramp II: Scamp's Adventure" (2001), "The Three Little Pigs" (1999), and "The Lion King II: Simba's Pride" (1998). In addition to his employment with Walt Disney, Darrell worked on several independent projects over the years. In 2003 Darrell's principal independent project involved Jean Harlow, a movie star of the 1930s, who died in 1937 at the age of 26. In preparation of writing the screenplay, Darrell accumulated an extensive research library on Ms. Harlow, comprised of more than 65 three-ring binders of printed materials and 25 binders of photographs of Ms. Harlow and other materials, including letters, historical documents, personal mementos, and vintage radio recordings on tape and CD and in transcript form. In addition, Darrell has research on numerous other projects, including Titanic Survivors, Cass Elliot, Calamity Jane, and Joan of Arc.

Darrell reported $308,373 in wages for his work as a director for Walt Disney. He attached to his 2003 return a Schedule C on which he described his principal business as that of a producer and filmmaker. The Schedule C reported no income or gross profit and a $20,843 loss of which $17,556 was a cost recovery deduction. Darrell or amortized most assets on a straight-line, 5-year basis. Darrell claimed depreciation and amortization expenses in two categories on his 2003 Schedule C: (1) the depreciation and §179 expense deduction category, and (2) the §197 amortization expense deduction category. Only the latter category was at issue. For simplicity, the court referred to the disputed category as the cost recovery deduction. The IRS disallowed in full the $17,556, contending:

1. that Darrell's expenditures, at least those related to the Ms. Harlow project, were personal because the expenditures were to enhance his personal collection rather than to carry on his business as a producer and filmmaker,
2. even if the relevant expenses were business expenses, the amounts spent on items related to Ms. Harlow were not reasonable, and
3. even if we were to conclude that depreciating the assets was proper, Darrell incurred the costs in the process of creating long-lived assets (the created assets) and should have been capitalized under §263A, which permits a taxpayer to recover costs only when the taxpayer places the created assets in service.

   Comment. The court did not rule on the IRS's §263A argument because it denied Darrell's cost recovery deductions on other grounds.

The court wasn't convinced that taxpayer's personal collection was going to be used for business purposes. The court determined that Darrell did not prove that the photographs or magazines he acquired in 2002 and 2003,were assets that have a limited economic useful life or were subject to wear and tear, decay, or obsolescence as a result of their use, if any, in his Schedule C activity. Moreover, while the items that Darrell added to his Harlow library related to one of his existing projects, Darrell also failed to demonstrate how those items were "used" in his business. Most importantly, Darrell didn't convince the court that the assets were not acquired primarily for his personal use and enjoyment, that the assets were actually placed into service in his Schedule C activity, or that the assets were depreciable or amortizable.

AUTOMOBILE EXPENSES

The 2011 Standard Mileage Rate For Business Driving is 51¢/ 55.5¢ (Notice 2010-88, Rev. Proc. 2010-51, IR 2011-69)

Medical and moving standard mileage rate is 19¢/23.5¢ per mile. The IRS provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred in operating a passenger automobile. In addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate.

	2009	2010	**1/1/through 6/30/11**	**7/1 through 12/31/11**
Medical and moving	24¢	16.5¢	19¢	23.5¢
Charity[21]	14¢	14¢	14¢	14¢
Business	55¢	50¢	**51¢**	**55.5¢**

2011 deemed depreciation per business mile is 22¢. To compute the basis of a vehicle when the standard mileage has been used (generally when the vehicle is sold), the depreciation component of the 51¢/ 55.5¢ standard mileage rate is 22¢ per mile (Notice 2010-88, Sec. 3; Rev. Proc. 2010-51, Sec. 4.04).

Year	Amount
2011	22¢
2010	23¢
2008 & 2009	21¢
2007	19¢
2005 & 2006	17¢
2003 & 2004	16¢
2001 & 2002	15¢
2000	14¢
1994 - 1999	12¢

Depreciation Deduction Limitations for Autos in 2011 (Rev. Proc. 2011-21)

Dollar limits are placed on the amount of annual depreciation claimed on "luxury" business autos in the year the auto is first placed in service (§280F). The §179 expensing election is also subject to the depreciation limits for luxury autos (§280F(d)(1)).

What does Congress call a "luxury" automobile? One costing more than $15,300 (Rev. Proc. 2011-21), the same as 2010 (Rev. Proc. 2009-54) and 2007 (Rev. Proc. 2007-30). A "luxury" automobile was $15,100 in 2009, 2008 and 2006 (Rev. Proc. 2009-24; Rev. Proc. 2008-22; Rev. Proc. 2006-18).

Autos on a truck chassis with GVW in excess of 6,000 excluded. Applicable automobiles include passenger cars weighing 6,000 gross vehicle weight (gvw) or less, which are manufactured primarily for use on public streets, roads and highways. Therefore light vans or trucks may be included whereas many full-sized pickups and large vans are excluded. Vehicles that by design or nature are not considered passenger cars (e.g., taxicabs, ambulances, and hearses) are also not subject to these depreciation limitations (§280F(d)(5)).

Heavy SUV's. Heavy SUVs (i.e., those that are rated at more than 6,000 pounds gross (loaded) vehicle weight) are also exempt from the luxury-auto limitations because they don't meet the specific definition of a passenger auto (see §280F(d)(5) for definition.) But, certain heavy SUVs may not elect to §179 expense more than $25,000 of their cost (§179(b)(6)). The balance of the heavy SUV's cost may be depreciated as 5-year MACRS property. For this purpose, a sport utility vehicle is defined to ***exclude*** any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver's seat, (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length, or (3) has an integral enclosure, fully enclosing the driver 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.

> **Note**. The GVW is listed on a metal plate on the inside of the driver's door. GVW can also be found at www.intellichoice.com.

One table for autos and a separate table for trucks and vans. There two sets of annual depreciation dollar limits for non-electric vehicles, one for passenger autos that are not trucks or vans and are subject to the §280F luxury-auto limits (i.e., rated at 6,000 pounds unloaded gross vehicle weight or less), and one for light trucks or vans (passenger autos built on a truck chassis, including minivans and SUVs built on a truck chassis). Light trucks or vans are subject to the §280F luxury-auto limits if they are rated at 6,000 pounds (loaded) vehicle weight or less (§280F(d)(5)(A)).

100% Bonus Depreciation Good For 2011

Congress reinstated bonus depreciation (§168(k)), effective through December 31, 2011, which means that autos and light duty trucks and vans used 100% for business are allowed additional first year depreciation of 50% of the cost of the vehicle up to a maximum of $8,000.

The maximum amount of depreciation that may be claimed on 100% business use luxury autos and trucks are (percentages are applied to original depreciable basis less bonus depreciation):

Rev. Proc. 2011-21	Auto - 2011	Trucks and Vans - 2011	Percent
1st year	$3,060 + $8,000	$3,260 + $8,000	20.00%
2nd year	$4,900	$5,200	32.00%
3rd year	$2,950	$3,150	19.20%

4th year	$1,775	$1,875	11.52%
5th year	$1,775	$1,875	11.52%
6th year	$1,775	$1,875	5.76%
next year	$1,775	$1,875	N/A

- The first-year depreciation on a new 2011 $60,000 luxury auto is $11,060.
- The first-year depreciation on a new 2011 $60,000 SUV (GVW of >6,000 lb) is $60,000.
- The first-year §179 on a $60,000 "non personal use" truck is $60,000.

When business use is less that 100%. If business use is less than 100%, the maximum depreciation deduction is reduced by the percentage of personal use (§280F(a)(2)). For example, if business use is 90%, depreciation is limited to 90% of each amount in the chart.

Leased Vehicle Inclusion Amount - In General (Rev. Proc. 2011-21)

To prevent avoidance of the personal use and luxury car limitations that apply to owned cars, a parallel system of limitations has been put in place for leased cars. Under this system, a taxpayer who leases a luxury car for business may be required to include an additional amount within his or her gross income in order to offset the deduction for the rental expense. The inclusion amount is calculated using annual tables provided by the IRS. The inclusion amount, based on the cost of the vehicle, applies generally to vehicles with a fair market value in excess of:

The lease term began in:	And the vehicle's FMV on the 1st day of the lease exceeded:
2011 (Autos, see table 5).	$18,500
2011 (Trucks and vans, see table 6)..	$19,000

Inclusion amount - calculation. §1.280F-7T provides that if a taxpayer leases a passenger automobile, the taxpayer must include in gross income an inclusion amount determined for each taxable year during which the taxpayer leases the automobile.

Calculation. For the appropriate range of fair market values and the table in §1.280F-7T, select the dollar amount from the column for the taxable year in which the automobile is used under the lease (but for the last taxable year during any lease that does not begin and end in the same taxable year, use the dollar amount for the preceding year).

1. Multiply the inclusion amount (found in Rev. Proc. 2011-21; Sec. 4.02) by a fraction equal to the number of days the car is leased during the year divided by 365.
2. Multiply the product in (1) by the car's percentage of business and investment during the year.

DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES §274

50% Of Meal and Entertainment Expenses Not Deductible (§274(n))

Deductions for any meals (food and beverages) and entertainment are limited to 50% of such allowable expenses even if they are incurred while traveling away from home (§274(n)).

80% of business meals deductible for transportation employees. Individuals may deduct a higher percentage of the cost of food and beverages while away from home during, or incident to, a period of duty subject to the hours-of-service limitations of the Department of Transportation.

Individuals subject to these limitations include:

1. Certain air transportation employees such as ***pilots, crew***, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations
2. Interstate ***truck operators*** and interstate ***bus drivers*** pursuant to Department of Transportation regulations
3. Certain railroad employees, such as engineers, conductors, train crews, dispatchers, and control operations personnel pursuant to Federal Railroad Administration regulations
4. Certain ***merchant mariners*** pursuant to Coast Guard regulations

Exceptions to the 50% Reduction Rule (i.e., These Are 100% Deductible Meals and Entertainment!)

There are ten exceptions to the 50% limitation rule:

1. **Reimbursed expenses - the self-employed independent contractor**
2. **Reimbursed expenses - employee (§274(e)(2))**
3. **The "Smithfield" Virginia Ham - De minimis (§274(n)(2)(B))**
4. **The company party (§274(e)(4))**
5. **Items available to public (§274(e)(7); LTR 94140040; LTR9641005)**
6. **Items sold to customers (§274(e)(8))**
7. **Charitable fund raising (§274(n)(2)(c))**
8. **Employer's reimbursement of employee meals considered moving expenses (§274(n)(2)(D))**
9. **Expenses for food or beverages required by any Federal law to be provided to crew members of commercial vessels** or expenses for food or beverages provided to crew members of a commercial vessel which is operating on the Great Lakes, the Saint Lawrence Seaway, or any inland waterway of the United States and which would be required by federal law to provide food and beverage if the commercial vessels were operated at sea (§274(n)(2)(E)(i & ii))
10. **Expenses for food or beverages provided at certain oil or gas platforms or drilling rigs and support camps (§274(n)(2)(E)(iii))**

Substantiation of Listed Property: Automobiles, Home Computers, But No Longer Cell Phones (SBJA 2010)

Finally - relief from Congress from onerous cell phone substantiation rules (SBJA 2010)! At the urging of taxpayers, IRS Commissioner Doug Shulman and Treasury Secretary Tim Geithner, Congress finally made

it to the 21st century and addressed the technological changes that have occurred to cell phones. As of Jan. 1, 2010, cell phones are no longer listed property. While this does not mean that there are no substantiation requirements to deduct cell phone expenditures, it does mean that the strict listed property contemporaneous log rules no longer apply to cell phones!

> **Comment.** A common-sense usage percentage can now be estimated. Notice 2009-46 proposed to allow 75% of an employer-provided cell phone to be considered used for business without substantiation, leaving 25% of the cost considered non-deductible personal use.

Items which must be substantiated before deducting listed property expenses:

1. **Amount**
   a. **Expenditures** - The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs or other expenditures, or uses.
   b. **Uses** - The amount of each business-investment use (as defined in §1.280F-6T(d)(3)) based on the appropriate measure ***(e.g., mileage for automobiles and minutes of use of home computers)*** and the total use of the listed property for the taxable year.
2. **Time** - The date of each expenditure or use.
3. **Business or Investment Purpose -** The business purpose for each expenditure or use (§1.274-5T(b)(6)).

Consistent Pattern of Business Purpose Provided Substantiation of Business Auto Expense (*Martin Barajas v. Comm*., TCS 2011-6)

In 2006, as he had for many years before, Martin Barajas used his knowledge of music industry production and his creative talents as a songwriter, photographer, and design artist to serve as a self-employed music producer. Barajas would meet with a music group or band and, depending on the group's needs, he would negotiate one of various types of multi-year contracts or licensing agreements. Barajas would agree to produce the group's music compact discs and/or its digital video discs. Barajas was also available to help with lyrics, to compose photographs, and to create artwork for the group's posters, business cards, and CDs. Once a group finished recording 10 to 20 songs and had decided on the final artwork, Barajas would subcontract with manufacturers to produce the posters, business cards, and CDs.

2006 business miles were 50,472. On his 2006 Schedule C, Barajas reported gross receipts of $152,061 and a net profit of $8,757. Among the business expenses, Barajas deducted car and truck expenses of $22,460. Barajas computed his vehicle expense deduction using the 2006 standard mileage rate of 44.5 cents per mile. He multiplied the rate times 50,472 business miles.

Taxpayer could only document 37 of his 48 business trips. Is that enough? The Court received into evidence a copy of a contemporaneous mileage log that Barajas maintained detailing his vehicle use for 2006. The log showed the dates, destinations, business contacts, and mileage for his business travel. The Court also received into evidence copies of manufacturer invoices, Barajas's canceled checks, and other supporting evidence corroborating a business purpose for 37 of taxpayer’s 48 trips to Los Angeles. IRS insisted on 100% corroboration of the mileage log. The Court found that this position contradicted the Secretary's own regulation.

Consistent pattern established. A taxpayer may substantiate his consistent pattern of business use of listed property for the entire year if he can establish by corroborative evidence that the periods for which he has adequate records are representative of the whole year (§1.274-5T(c)(3)(ii)(A)).

Examples in Regs allow partial-year log. The regulation provides three examples to illustrate this point. The first two examples show acceptable support for a log, and the third example shows unacceptable support. Sec. 1.274-5T(c)(3)(ii)(C). In the first example, the taxpayer maintained adequate records for the first 3 months of the year, and in the second example the taxpayer provided records for the first week of every month. Thus, in the first two examples, the taxpayers had corroborative records for only one-quarter of the year. Nonetheless, because the taxpayers maintained consistent driving patterns throughout the year, their partial substantiation was adequate to corroborate the log for the entire year. The third example illustrates unsatisfactory substantiation. The third taxpayer similarly provided documentation for one-quarter of the year; the last week of every month. The taxpayer's critical failure, however, was that the last week's business use pattern was not reflective of his driving pattern during the rest of the month. Therefore, the taxpayer's partial substantiation was "not representative of use during other periods."

Criminal Tax Preparer Probably Not the Best Substantiation of Auto Expenses (*Sandra Lee. Bennett v. Comm.*, TCM 2010-114)

Sandra Bennett was a self employed real agent working in St. Paul, MN. To prepare her 2005 returns Sandra hired Robert Wicker, a tax preparer who had been convicted of aiding and abetting multiple clients in fraudulently preparing their tax returns and for fraudulent preparation of his own personal tax returns. Wicker fabricated a mileage log which he used to compute Sandra's 2005 auto expense deduction of $13,030. The court noted Wicker's lack of credibility and, absent a contemporaneous log, disallowed the entire deduction.

- *Ming Zeng v. Comm.*, TCS 2010-77, Oncologist's mileage log prepared after audit notice received not contemporaneous.
- *Diana M. Coury v. Comm.*, TCM 2010-132, insurance agent denied additional auto expenses without requisite mileage log.
- *Ena M. and Brian R. Fleming, pro se v. Comm*, TCM 2010-60, Sch. C deductions disallowed without adequate substantiation.
- *Paul and Melody Fucaloro, pro se v. Comm.* TCS 2010-37, unlicensed would-be sport agent failed to carry burden of establishing profit motive for purpose of Schedule C expenses, both in documentary evidence to satisfy §274(d) as well written and testimonial evidence sufficient as "ordinary and necessary" expenses under §162(a)).

Listed Property Rules Do Not Apply to Limo Driver, Cohan Rule Allowed (*Asif Hafeez, pro se v. Comm.*, TCS 2010-109)

Asif Hafeez was a professional driver working as an independent contractor in the New York City area. Car service companies would advertise and attract fares, which they would then dispatch to Asif and other drivers. Asif paid all operating costs for his vehicle and split amounts received from fares with the car service companies. The vast majority of his annual expenses related to his vehicle and the IRS disallowed most of these expenses due to lack of substantiation.

Cohan rule to the rescue. Courts may approximate the amount of an allowable deduction for taxpayers who establish they've paid or incurred a deductible business expense but are unable to establish the amount. When

making such approximations, the court bears heavily against the taxpayer whose inexactitude is of his or her own making (*Cohan v. Commissioner,* 39 F.2d 540, 543-544 (2d Cir. 1930)). Normally, certain expenses (auto expenses) may not be estimated under the Cohan rule because of the strict listed property substantiation requirements of §274(d). However, the term "passenger automobile" does not include any vehicle used by a taxpayer directly in the trade or business of transporting persons for compensation or hire (§280F(d)(5)(B)(ii); §1.280F-6(c)(3)(ii)). While the court did not allow the total amounts claimed by Asif on his tax returns as business expenses, it did rely on his credible testimony and skimpy documentation to allow amounts it deemed reasonable.

OTHER GENERAL TRADE OR BUSINESS EXPENSES

Expense of a Caregiver to Allow Taxpayer to Work is not Deductible (*Joseph Kuntz III and Syrita E Kuntz v. Comm.*, TCM 2011-52)

Idaho contractor allowed business deduction only for caregiver's clerical work. Joseph Kuntz was self-employed as a tile and marble contractor. He operated his business out of the Kuntzes' personal residence. Mrs. Kuntz had Alzheimer's disease, and her condition required someone to be with her at all times. Joe employed a caregiver to look after Mrs. Kuntz during the day. The caregiver also did clerical work for Joe's business. Mr. Kuntz paid $20,184 to the caregiver in 2006 and $20,265 in 2007. The total payments were deducted on Joe's Schedule C.

The IRS allowed $2,115 of the $20,184 paid to the caregiver in 2006, and $2,115 of the $20,265 paid to the caregiver in 2007, as deductible business expenses because of the caregiver's clerical services. But, the IRS allowed only $13,490 in 2006 and $12,143 in 2007 of the amount paid to the caregiver to be deducted as medical expenses on Schedule A. For some reason, Joe agreed that to this amount if he lost the business deduction.

> **Comment.** The Kuntzes did not claim a §21childcare credit, which would have allowed a credit for a percentage of the expenses of caring for a spouse who is "physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer" if "such expenses are incurred to enable the taxpayer to be gainfully employed."

A Real Estate Professional Can Pay and Deduct A Customer's Property Taxes to Protect an Income Stream! (*Donald Wm. Trask v. Comm., pro se;* TCM 2010-78)

Before 2001, Donald Trask held a mortgage on real property owned by Occidental Financial Group, Inc. (Occidental), in San Bernardino, California. Donald did not own shares in Occidental but lent $400,000 to the company in exchange for a deed of trust on the property. Donald lent the money to guarantee an interest income stream for himself. As owner of the property, Occidental was liable to pay the property tax, but went bankrupt. The bankruptcy court revised the terms of Donald's note, and Occidental made a few payments, but the payments eventually ceased.

The court held that Donald was entitled to a $14,829 property tax deduction in 2001 as he was a real estate professional, and in order to keep possession of the Occidental property, he was required to pay the property tax to prevent the county from seizing it to collect for nonpayment.§162 allows a deduction for all ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business, including rentals or other payments required to be made as a condition to the continued use or possession of property (§162(a)(3)).

Comment. Realtors® commonly pay a customer's legal and preparation fees to protect their future commission income (called a commission-ectomy). This case lends credence to the position that paying another's debt can be deductible as a business expense. Interesting case.

DEDUCTION - REPAIRS & DEPRECIATION

§162 and §263 - Repair vs. Capitalize

Section 162(a) authorizes a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". A trade or business expense is **ordinary** for purposes of §162 if it is ***normal or customary*** within a particular trade, business, or industry and is **necessary** if ***appropriate and helpful*** for the development of the business. Conversely, §263 generally prohibits deductions for "**capital** expenditures paid out for ***permanent*** improvements or betterments made to ***increase*** the ***value*** of any property". By contrast, a repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition" (*Ill. Merch. Trust Co. v. Comm*., 4 B.T.A. 103, 106 (1926)).

Context is decisive. The deductibility of repair expenses also depends upon the context in which the repairs are made. Expenses incurred as part of a ***general plan of rehabilitation*** must be capitalized even if they would have been deductible as ordinary and necessary business expenses if separately incurred (*US v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968); *Norwest Corp v. Comm*., 108 T.C. 265, 280 (1997)).

What Kind of Property Is Depreciable?

Generally, depreciable property is:

1. ***A capital expenditure in depreciable property;***
2. Used in a trade or business or held for the production of income; and
3. Has a definite useful life of more than one year (§167 & 168).

Requirement 1: Capital expenditures in property. Capital expenditures include the acquisition costs of property as well as subsequent improvements that increase the property's value or prolong its useful life.

Requirement 2: Property used in a trade or business or for the production of income. Depreciation is allowed only for property that is used in a trade or business or that is held for the production of income (§167(a)). Therefore, personal property, such as a personal residence or personal automobile, may not be depreciated.

Requirement 3: Useful life of more than one year. The useful life of an asset is the period over which the asset is reasonably expected to be useful in a trade or business or for the production of income. In order to be depreciable, an asset must have a useful life of more than one year. If the life is one year or less, it is to be expensed in the year placed into service (normally the year of acquisition).

Repair vs. Improvement Regulations

The tests to determine if a future replacement or improvement is to be expensed (as repairs) or depreciated (as capital expenditures) are:

1. Does it materially add to the property's value, or
2. Does it prolong the property's useful life (§1.263(a)-1(b))

Audit Technique Guide Released on Capitalization Versus Repair (ATG Capitalization v. Repair, Nov. 22, 2010)

The IRS released a new audit technique guide to assist its examiners in determining whether an expenditure should be capitalized or deducted. The ATG discusses the unit of property (UOP) definition and current case law on the UOP issue.

The current regulations do not define "property" for purposes of determining whether an amount adds value to the property, prolongs the useful life of the property, or adapts the property to a new or different use. Even though §162 and §263(a) are silent on the definition of UOP, court cases dealing with personal property and plant property provide a number of factors that may be considered for this determination. These factors include:

1. Whether the property is manufactured, marketed, or purchased separately;

2. Whether the property is treated as a separate unit by a regulatory agency, in industry practice, or by the taxpayer in its books and records;

3. Whether the property is designed to be easily removed from a larger assembly, is regularly or periodically replaced, or is one of a fungible set of interchangeable or rotable assets;

4. Whether the property must be removed from a larger assembly to be fixed or improved;

5. Whether the property has a different economic life than the larger assembly;

6. Whether the property is subject to a separate warranty; and

7. Whether the property serves a discrete purpose or functions independently from a larger assembly.

THE OFFICE-IN-HOME REQUIREMENTS - §280A

Strict Office-in-Home Rules Prevent Abuse

To deduct expenses related to the business use of part of the home, the taxpayer must meet specific requirements. Even then, the deduction may be limited. For home office expenses to qualify for a deduction, the portion of the home that is used for business must:

1. be used *exclusively*, (however, exceptions exist, see: *James A. & Joan H. Soholt v. Comm.*, TCS 2007-49, few personal papers in the home office didn't disqualify home office deduction)
2. on a *regular* basis,
3. in connection with a *trade or business*, AND

in ***one*** of the following ways:

4. as the *principal place of business* for any of the taxpayer's trade or business; or
5. as a place of business for meeting or dealing with patients, clients or customers in the ordinary course of business, or
6. in connection with the taxpayer's trade or business if the taxpayer is using a separate structure that is not attached to the dwelling (§280A(c)(1)).

Being the most common method, a home office qualifies as the taxpayer's "principal place of business" if: *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*. This means that outside salespersons and real estate agents will often be able to deduct an office in their home.

> **Warning.** No "investment" offices. The "principal place of *business*" rule makes personal investment activities (e.g., reading financial periodicals, clipping bond coupons, etc.) ineligible for home-office deductions as they don't rise to the level of a "business" activity (*J.A. Moller*, CA-FC 83-2 USTC ¶9698, 721 F2d 810).

Can we deduct an office-in-home for managing a real estate rental reported on Schedule E?" The court ruled in the *John M. Rodriquez v. Comm.* case (TCM 2009-22) that John conducted rental real-estate business in his home office and allowed a home office deduction on Schedule E.

The meaning of *home*. The term home includes a house, apartment, condominium, mobile home, or boat. It also includes structures on the property, such as an unattached garage, studio, barn, or greenhouse. However, it does not include any part of the property ***used exclusively*** as a hotel or inn (§1.280A-1(c)(2)).

Two more limitation rules apply to employees. In the case of a home office used by an employee, the employee must also establish that the use of the home office is for the convenience of his or her employer [§280A(c)(1)(flush)] and (2) the employee **does not** rent all or part of the home to the employer and use the rented portion to perform services as an employee (§280A(c)(6)).

The "convenience of employer" rule. Whether the home's business use is for the employer's convenience depends on all the facts and circumstances. However, business use is not considered for the employer's convenience merely because it is appropriate and helpful.

Employee renting office-in-home to employer doesn't work. §280A specifically disallows the deduction of any expenses incurred when an employee rents a personal residence to his employer for business purposes (*L.A. Roy,* TC Memo 1998-125). Therefore, even a home office deduction is barred when an employee leases a portion of his or her home to the employer at fair market value. This rule also extends to an independent contractor who attempts to lease to the party for whom he or she perform services (e.g., a real estate agent should not lease office space located at home to his or her broker/owner) (§280A(c)(6)).

> **Comment.** A landlord can rent real estate to an employer whereas an employee will lose his or her deductions if she or he rents a personal residence to an employer. For example, William Cutts successfully leased 95% of his personal residence to a corporation in which he was the CEO and major shareholder (*William J. Cutts v. Comm.,* TCS 2004-8). To avoid this limitation, a written lease

agreement needs to establish a landlord-tenant relationship and not an employer-employee relationship.

25% Home Office Allowed (*Xianfeng Zhang v. Comm.*, TCS 2011-21)

Xianfeng Zhang sold travel insurance primarily for trips to China, performing administrative and management activities related to the sales in a home office. The home office was approximately 25% of the total area of his home. His employer did not provide Zhang with an office. Even though he shared his house with his parents and his son, the court felt he credibly testified that his family members did not use the home office and credibly testified that he used the 25% exclusively for trade or business purposes.

Comment. 25% is an unusually high percentage!

No Home Office Deduction Even Though LA Times Provides Horse Racing Writer a Desk, But No Chair *(Willard Michael Christine pro se v. Comm.*, TCM 2010-144)

Even inadequate employer-provided office can result in disallowance of home office deduction. When Willard Christine first began his employment with the L.A. Times, the Times provided him with a desk and chair; but a few years later he came into the office to find his chair was missing. Mr. Christine explained that there were approximately 60 sports journalists working for the L.A. Times and if "as many as half of us had ever shown up on the same day we would have been working from one another's laps".

The fact that an employer provided inadequate office facilities was not dispositive of whether a home office was for the convenience of the employer (See *Dudley v. Comm.*, T.C. Memo. 1987-607, affd. without published opinion 860 F.2d 1078 (6th Cir. 1988)). However, it was unclear to the Court whether Mr. Christine was able to conduct his book-writing activity at the L.A. Times. Therefore, the Court was required to examine whether Mr. Christine's home office was his principal place of business and vital to his profession as a writer.

The court concluded that although it might have been inadequate, the L.A. Times did provide Mr. Christine with an office. Additionally, on the basis of the record, the Court could not conduct an accurate comparison of the time Mr. Christine spent writing at his home relative to the time he spent working elsewhere or determine that a home office was vital to his profession. Accordingly, the Court found that Mr. Christine failed to meet the requirements of §280A(c)(1)(A) and was not entitled to a deduction for the expenses of maintaining a home office.

Property Used Both For Business and Personal Purposes

Where a facility serves both business and personal purposes, an allocation must be made by comparing the space and/or time devoted to business use with total use. The primary purpose criterion, governing the deductibility of expenditures related to both business and personal purposes, applies only to cases in which the secondary purpose is merely incidental and relatively insignificant. Where only less precise measurements can be made, the allocation is made on the basis of an evaluation of the total circumstances (*Intl. Artists, Ltd. v. Comm*., 55 T.C. 94 (1970); *Eden v. Comm*., T.C. Memo. 1987-101; *Heuer v. Comm*., 32 T.C. 947 (1959), affd. 283 F.2d 865 (5th Cir. 1960)).

Calculation of Business Percentage

Previously, the business percentage was determined either by dividing the square footage of the office-in-home by the total square footage of the home (e.g., 200-square-foot office ÷ 3000-square-foot home = 6.67%) *or* by dividing the office room by the number of rooms in the house (e.g., 1 room ÷ 10 rooms = 10%) and using the percentage most advantageous to the taxpayer. No more!

Use the square-footage method because room-by-room allocation is no longer permitted. According to the instructions of Form 8829, the room-by-room method is available only if "the rooms in the house are all about the same size" (i.e., each bathroom is the same size as the living room, etc.), which is a ridiculous requirement. In a recent court case, Edward Andrews claimed a deduction based on the ratio of rooms in the house, but the court determined that the home-office expenses should more reasonably be allocated on a square-footage basis (*E. W. Andrews v. Comm.*, 60 TCM 277, TC Memo 1990-391; CA-1 91-1 USTC ¶50,211; *A. Swain*, CA-4, 96-2 USTC ¶50,480).

> **Caution - Make it a sensible percentage**. A tattooer's office occupying 59% of her home, including her entire living room and dining room, her entire bathroom, and the portion of the kitchen containing the sink, was found implausible by the court (*Karan M. Hintze v. Comm.*, TC Memo 2001-70). A psychologist's 400-square-foot apartment in San Francisco was considered too small to have any space used exclusively to meet patients (*Erin Mullin v. Comm.*, T.C. Memo. 2001-121). An IRS agents claim that home office was 42% of residence was reduced by the court to 13% (*Henry J. And Patricia K. Langer v. Comm.*, TCM 2008-255).

DOMESTIC PRODUCTION DEDUCTION - §199

***NEW!* §199 "Phantom" Deduction Fully Phased in at 9% (§1.199 final regulations; T.D. 9384; T.D. 9263)**

Effective for tax years beginning after December 31, 2004, the 2004 JOBS Act provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning in 2010 the deduction is equal to 9% of the lesser of: (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this provision) for the taxable year. For taxable years beginning in 2005 and 2006 the deduction was 3%, in 2007, 2008 and 2009 it was 6%. §199(b)(1) further limits the deduction for a taxable year to 50% of the qualified production activity W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year.

The §199 deduction is claimed on the one page Form 8903. If an individual taxpayer filing on Schedule C is eligible for and claims the deduction on Form 8903, the deduction is treated as an adjustment to income on line 35 of Form 1040, NOT on Schedule C. As a result, the §199 deduction does not enter into the computation of self-employment tax on Schedule SE.

> **Example.** Barry is a self-employed engineer. His gross Sch. C income (which all qualifies as domestic production gross receipts) is $300,000. His direct and indirect costs equal $125,000. Thus, qualified production activity income (and taxable income) is $175,000 ($300,000 - $125,000).

Included in the direct and indirect costs is $40,000 paid to an independent contractor for drafting services and $3,000 of W-2 wages paid for part time secretarial services. Barry's production activity deduction is NOT $15,750 (9% of $175,000 QPAI). The deduction is limited to $1,500, 50% of W-2 wages. Neither Barry's self employment income nor his payments for independent contractor services are included for purposes of the W-2 wage limitation.

Planning Point. A sole proprietor or a partnership with no W-2 wages might consider:

1. Hiring a spouse or child as an employee, or
2. Transferring the business to an S corporation and paying wages to the owner.

Qualified production activities. To qualify for the deduction, the taxpayer must have income from a qualified production activity. The following activities are qualified production activities:

1. The manufacture, production, growth, or extraction in whole or significant part in the United States of tangible personal property (e.g., clothing, goods, and food), software development (both in disk and downloadable format), or sound recordings.
2. Any qualified film produced by the taxpayer. A qualified film includes any motion picture film or video tape (other than certain sexually explicit visual depictions), as well as live or delayed television programming. The definition also requires that not less than 50% of the total compensation relating to the production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers (§199(c)(6)). "Qualified film" is limited to the master copy and does not include copies of the film. Thus, the sales of DVDs or video cassettes are not qualified production activity income. Beginning in 2008, W-2 wages include *any* compensation for services performed in the U.S. by actors, production personnel, directors and producers. Also beginning in 2008, a qualified film will not be affected by the methods and means of distributing the film (even if film viewed online or downloaded only).
3. U.S. production (but not the transmission or distribution) of electricity, natural gas or potable water.
4. Construction or substantial renovation of real property in the United States including residential and commercial buildings and infrastructure such as roads, power lines, water systems and communications facilities. Gross receipts from the sale of land is disqualified income.
5. Engineering and architectural services performed in the United States and relating to construction of U.S. real property.

Limitation of Deduction for Income Attributable to Domestic Production of Oil, Gas, or Primary Products (Emergency Economic Stabilization Act of 2008)

§199 deduction for oil and gas companies limited to 6% beginning in 2010. The §199 deduction for taxpayers with oil related qualified production activities income for any taxable year beginning after 2009 is reduced by 3% of the least of: (1) oil related qualified production activities income of the taxpayer for the taxable year; (2) qualified production activities income of the taxpayer for the taxable year; or (3) taxable income (determined without regard to the §199 deduction). The term "oil related qualified production activities income" means qualified production activities income for any taxable year which is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof during such taxable year.

BUSINESS ACCOUNTING PERIODS AND METHODS

IRS Releases ATG for Cash Businesses (Cash Audit Technique Guide)

The accurate reporting of income and expenses by cash intensive businesses has been the subject of various studies by the IRS, as well as GAO. The GAO estimates that the individual income tax "gap" is in the hundreds of billion of dollars. The common theme of these studies is that there has been, for those taxpayers with the ability to determine their own reported income, an increasing under reporting of income.

Of particular interest to the IRS are businesses and individuals who receive most of their income in cash. Cash transactions are anonymous, leaving no trail to connect the purchaser to the seller, which may lead some individuals to believe that cash receipts can be unreported and escape detection.

IRS gives examples of cash businesses headed for more scrutiny. The ATG gives special attention to the following cash businesses with a chapter on: bail bond, beauty and barber shops, car wash, coin operated amusement, convenience stores and scrap metal dealers.

Conducting a required minimum income probe. Examiners must conduct a minimum income probe on businesses under examination. Minimum probes include: analysis of financial status (cash T), interview of the taxpayer, tour of the business, evaluation of internal controls, reconciliation of income to books, testing of gross receipts, analysis of bank accounts, analysis of business ratios, and an analysis of E-commerce activity.

Pre-Audit techniques. The IRS examiner is instructed in the ATG to review internal documents and do a public records check. Ratio analyses are extremely important in evaluating the reasonableness of reporting in a cash intensive business or in a business that carries inventory.

Taxpayer interview. The IRS tells its examiners that the initial interview of the taxpayer sets the stage for the rest of the examination. “The primary purpose of the interview is to secure, by conversation with the taxpayer, facts which will present the taxpayer’s overall financial picture, an understanding of the operations, and an overview of the recordkeeping practices . . . the taxpayer will be more responsive at this time than later in the audit. Answers will be less biased because no issues are at stake.”

The POA instead of the taxpayer at the interview. §7521(c) provides for the appearance of representatives with valid Powers of Attorney on behalf of taxpayers. This section states “an officer or employee of the Internal Revenue Service may not require a taxpayer to accompany the representative in the absence of an administrative summons.” If however, information necessary for the determination or collection of tax is not, or cannot be provided by the representative, then Service personnel have the authority to administratively summon the taxpayer to personally appear to provide testimony or records deemed necessary by the officer or employee working the case.

Vertical analysis. The first step in determining the reasonableness of the reported income and expenses is a vertical analysis that expresses each expense in terms of gross receipts. This is the method companies use to compare one business to another. www.Bizstats.com offers free business statistics and financial ratios, by type of entity (sole proprietor, corporation, partnership), by industry (retail, beverage store, construction, etc.)

and by amount of gross receipts. By entering the amount of gross receipts from the return into the Bizstats customized P&L report for the proper industry, Bizstats will prepare a benchmark vertical analysis that can be compared to the tax return. This analysis will tell the IRS how the business under audit compares with the industry as a whole. This does not indicate there is unreported income, but may raise some questions about the expenses that should be asked of the taxpayer.

The new IRS audit technique guide for cash business is intended to highlight how auditors should look for under reported cash receipts.

Misappropriating cash. There are three main ways to misappropriate cash from a business.

- It can be skimmed from receipts, for example, pocketed before it is recorded. If this happens, it will not be discovered by auditing the books.
- It can be stolen after it has been recorded, for example, cash removed from the cash register or goods stolen from the shelf for future resale.
- A fraudulent disbursement can be created, for example, a payment to a vendor that is actually cashed by the owner's son.

Indicators of under reported income. The most significant indicator that income has been under reported is a consistent pattern of losses or low profit percentages that seem insufficient to sustain the business or its owners. Other indicators of unreported income include:

- A life style or cost of living that can't be supported by the income reported.
- A business that continues to operate despite losses year after year, with no apparent solution to correct the situation.
- A Cash T shows a deficit of funds.
- Bank balances, debit card balances and liquid investments increase annually despite reporting of low net profits or losses.
- Accumulated assets increase even though the reported net profits are low or a loss.
- Debt balances decrease, remain relatively low or don't increase, but low profits or losses are reported.

- A significant difference between the taxpayer's gross profit margin and that of their industry.
- Unusually low annual sales for the type of business.

IRS examiners must hunt for unreported income. If the IRS wants to find income, they must actively look for income. Unlike examining expenses, which can either be verified or not, hidden income is harder to find and requires a proactive approach. There are several techniques that can be used successfully when working with cash intensive businesses.

Financial status analysis. A financial status analysis including both business and personal financial activities should be done. This is a required minimum income probe. If it shows an imbalance in the cash flows indicative of underreported income, request clarification or explanation from the taxpayer before beginning the use of an Indirect Method (Financial Status Audit Techniques).

> **Note**. IRM 4.10.4.6.1 addressed the requirements for Examining Income and Using Financial Status Audit Techniques (FSATs). It discusses the prohibition of the use of Financial Status Audit Techniques to determine the existence of unreported income unless a reasonable indication that there

is a likelihood of unreported income has been established. A reasonable likelihood can be established with the initial unresolved financial status analysis (T account).

Indirect methods. Indirect methods, such as a fully developed Cash T, percentage mark-up, source and application of funds or bank deposit and cash expenditures analysis, can then be used to confirm the amount of any understatement. Seek your Area Counsel's opinion regarding the use of non-conventional techniques prior to initiating any action.

Other analysis. Comparative analysis of a three-year income and a four-year balance sheet is an important step for the examiner. An analysis of inventory with inventory turnover, the change to cost of goods sold and gross profit margin from year to year are also recommended to the IRS auditor.

Sources and Applications of Funds Method Used Against CPA w/Master Degree (*Abdul Med Bangura v. Comm.*, TCS 2011-23)

CPA's Schedule A expenses almost 8 times Schedule C income. Abdul Med Bangura received a master's degree in accounting and taxation from Southeastern University in Washington, D.C., and is a CPA licensed in Maryland. In the year at issue, 2007, Abdul was the owner and sole proprietor of AMB CPA Services, providing tax preparation services for 75 to 100 clients. Abdul is currently pursuing a law degree. The IRS examiner, James Brown[22], felt that the relatively small amount of income Abdul reported on his 2007 income tax return ($28,500) "did not support the itemized deductions ($37,984) and the Schedule C expenses ($23,615) as stated on the tax return

> **Comment.** Abdul's Schedule C reported $4,885 of net income. What would be questionable about that amount of income being sufficient to pay $32,842 mortgage interest expense and $5,142 of state/local taxes?

Sources and applications of funds used. The IRS agent issued 3 different IDRs (Information Document Requests). Because Abdul's bank records were not "illuminating," the agent used the source and application of funds method to reconstruct Abdul's income for 2007. The source and application of funds method reconstructs the estimated amount of the taxpayer's income by determining the excess of the taxpayer's expenditures for the year over his known sources of income. Guidelines are found in the Internal Revenue Manual (IRM). Agent Brown determined Abdul had an excess application of funds, i.e., unreported income for 2007, totaling $73,036 ($101,536 estimated income -$28,500 income reported on Schedule C).

In estimating Abdul's personal living expenses (e.g., food, housing, transportation, etc.) Agent Brown used the BLS Consumer Expenditure Survey for the south region, which is the region for Maryland. Because he used Abdul's actual expenses with respect to the reported mortgage interest, property taxes, and State and local taxes, he subtracted the survey's estimates for these items from his calculation. Although Agent Brown used the business expenses set forth on Schedule C in reconstructing Abdul's income, he determined that deductions for these expenses should be disallowed for lack of substantiation.

However, the court felt it was not reasonable, and did not allow, Agent Brown to disallow Adbul's deductions for lack of substantiation and, at the same time, use the same amount in determining his cash expenditures!

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[22] The "Godfather of Soul", James Brown (I Feel Good) died December 25, 2006!

START-UP EXPENSES - §195

Start-Up Expenses

Background: Except as otherwise provided in §195, no deduction is allowed for "start-up expenditures." However, start-up expenditures may, at the election of the taxpayer, be treated as "deferred expenses" beginning in the month the "active trade or business begins" (§195(b)). Under §195(c)(1)(A), a "start-up expenditure" includes any amount paid or incurred in connection with:

1. Investigating the creation or acquisition of an active trade or business;
2. Actually creating an active trade or business; or
3. Any activity engaged in for profit and for the production of income *before* the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

Finally, the expenses are "start-up expenditures" only if they would be allowable as a deduction for the taxable year in which paid or incurred if they were paid or incurred in connection with the operation of an existing active trade or business (in the *same* field as the trade or business referred to in §195(c)(1)(B)).

> **Comment.** This section is not intended to change the coverage of §248 or §709, which respectively provide for the amortization or deduction of corporate and partnership organizational expenditures.
>
> **Example**. Ron paid his attorney $23,000 to form and write the operating agreement for his new LLC which began business October 2010. Ron is entitled to expense the first $10,000 of these start up expenses. The remaining $13,000 of legal fees is amortized over 15 years.

New! First Year Start-up Deduction Increased to $10,000 Beginning in 2010

15-year amortization for intangibles but $10,000 first year deduction available if cumulative costs do not exceed $60,000. A taxpayer is allowed to elect to deduct up to $10,000 for years beginning in 2010 of start-up expenditures in the taxable year in which the trade or business begins. However, the $10,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $60,000 in years beginning in 2010. Prior to 2010, the taxpayer was only permitted to deduct up to $5,000 of start-up costs as long as the total start-up expenses didn't exceed $50,000. Start-up expenditures that are not deductible in the year in which the trade or business begins are amortized over a 15-year period consistent with the amortization period for §197 intangibles.

Amortization starts the month that the active conduct of the business begins. This occurs by applying the going concern test, that is, when the business begins to function as a going concern and performs those activities for which it was organized. For existing businesses, expenses in connection with the expansion fo the business are not considered start-up expenses.

Election to Amortize Organization or Start Up Expenses (TD 9411, NPRM REG-164965-04)

Formal written election is no longer required. The IRS now allows a deemed election to expense and amortize start up and organizational expenses. Acknowledging that most businesses choose to expense and amortize these kinds of expenses, the IRS no longer requires a formal written election.

The election is made by reporting it on a timely filed return. The temporary regulations provide that taxpayers are deemed to make an election under §195(b) to deduct up to $5,000 of start-up expenditures and to amortize any remaining amounts. Taxpayers are no longer required to attach a statement to the return or specifically identify the amount deducted as start-up expenditures. Taxpayers may choose to forgo the deemed election by clearly electing to capitalize its start-up expenditures on a ***timely filed*** Federal income tax return (including extensions). An election either to deduct start-up expenditures or to capitalize start-up expenditures is irrevocable and applies to all start-up expenditures of the taxpayer that are related to the active trade or business.

§195 - Five of Six Internet Activities Were Startups - Expenditures Subject to §195 Limitations (*Muhammad Ahmed Alvi v. Comm. pro se*, TCS 2010-79)

Muhammad Ahmed Alvi, an Illinois Physician with six online retail Websites, reported $4,387 of gross income and $55,067 of total expenses on one 2005 Schedule C under the single business name of SkillsSoft/Edokan. The issue was whether those online activities generating losses were going concerns, or if the expenses were §195 startup expenses.

Alvi's activities consisted of: (1) Edokan, an online retail sales Web site; (2) efattofit.com, a weight loss Web site, designed to assist consumers with determining their body mass index and calculating their body's optimal caloric intake; (3) Desi, a Pakistani language video and music Web site; (4) an individual weight loss software program; (5) a software program for Urdu to English and English to Urdu translation and an Internet-based dictionary; and (6) software for a physician's desk reference guide. Edokan was the only activity to generate income in 2005. Alvi hired several employees to develop the activities, and the employees performed work for all of the activities using the same tools, software programs, and resources. Interestingly, Alvi did not develop or reduce to writing a business plan or have a written advertising or marketing plan for his activities. Although he planned to generate revenue through advertising sales, he did not maintain or develop a potential customer list for his activities.

Alvi admitted that SkillsSoft was focused on demonstrating its expertise as a software development company, creating the Web sites for his own activities in order to show potential clients that it was capable of providing efficient and cost-effective software development services. The court pointed out that in order for Alvi to be carrying on a trade or business, however, the business must function as a going concern and its services must be held out to the public. There was no credible evidence, beyond Alvi's testimony, that SkillsSoft's services were actually being held out to the general public.

> **Comment.** As the Websites are all active (see: www.skillssoft.com) I'm not certain how the court came to this conclusion!

Alvi testified that Desi, efattofit.com, the online dictionary, and the software development associated with his activities were operating during 2005. Nevertheless, he admitted that SkillsSoft was still developing these activities during 2005. He presented no further evidence to corroborate his testimony that these activities were operating in 2005 and the Court was unable to conclude that these activities were operating as a going concern, open to the public during 2005 or that they commenced business operations in 2005. Consequently, the court concluded that the expenses associated with these activities were nondeductible startup expenditures.

BUSINESS CREDITS §38 - 45F

General Business Credit

The general business credit is the sum of various business tax credits (e.g., investment tax credit, research and development credit, disabled access credit, etc.) for the current year plus any general business credits carried forward from prior years. Excess general business credits are allowed to be carried back one year and carried forward up to 20 years.

***New!* General Business Credit Carryback Increased From One to Five Years for Eligible Small Businesses, AMT Limitations Waived (Small Business Jobs Act of 2010 (SBJA))**

5-year carryback for eligible small businesses. For years beginning after December 31, 2009, eligible small businesses are allowed to carry back general business credits up to 5 years (§39(a)(4)). The general carryforward period remains 20 years.

AMT limitations waived. For taxable years beginning before January 1, 2010, certain underlying component credits of the general business credit were not allowed against alternative minimum tax. For years beginning in **2010 only**, eligible small businesses may use 100% of the general business credit against regular and alternative minimum tax, regardless of what underlying credits make up the general business credit (§38(c)(5)).

Eligible small business. For these purposes, an eligible small business is defined as a corporation, the stock of which is not publicly traded, a partnership or a sole proprietorship whose average annual gross receipts for the 3 prior years were less than $50 million (§38(c)(5)(C)). Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current year business credits.

Research Tax Credit Expires December 31, 2011 - §41; Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (P.L. 111-312)

The research credit has been extended through December 31, 2011. The §41 research tax credit has never been a permanent provision of the federal tax code. Since its enactment in mid-1981, the credit has been extended 14 times and significantly modified five times (a.k.a. extended 19 times). While the credit is often thought of as a single unified credit, it has five components (reduced to four components in 2009): (1) a regular credit, (2) an alternative incremental credit (AIRC) (terminated for tax years after December 31, 2008), (3) an alternative simplified credit (ASIC) [increased from 12% to 14% of the qualified research expenses that exceeds 50% of the average qualified research expenses for the prior three tax years starting for tax years ending after December 31, 2008], (4) a basic research credit, and (5) an energy research credit. All but the energy research credit are incremental in that the credit applies only to qualified research spending above a base amount.

Business Credit for Retaining Newly Hired Individuals (IRS FAQs on Retention Credit)

$1,000 or 6.2% of wages if worker retained for 52 *consecutive* weeks. For taxable years ending after March 18, 2010, the employer's §38(b) business credit will be increased, with respect to each retained worker employed by the taxpayer for not less than 52 consecutive weeks, by the lesser of:

1. $1,000, or
2. 6.2% of the wages paid by the employer to such retained worker during the 52-week period.

> **Comment.** As business credits reduce taxes due to the IRS, non-profit corporations and state colleges and universities who qualify for the payroll tax matching waiver will not benefit from this retention credit. We think, though, it might be available against unrelated business income tax paid by these non-profit entities.

> **Comment.** Any employer paying more than $16,129 in that 52-week period to a qualified employee will receive the maximum of $1,000. That is approximately a $7.75 average per hour rate for a full time worker.

Credit for retaining qualified workers not available until 2012. Because the up-to-$1,000 business credit may be claimed only after a worker has been retained for at least 52 weeks and the effective hiring date for the first qualifying worker is February 4, 2010, this puts the availability date no earlier than 2011. For calendar-year employers, this credit will be claimed on their 2011 tax return filed in 2012.

To prevent any retroactive benefit, any unused retained worker retention credit can't be carried back to a taxable year beginning before March 18, 2010.

Employer can't pay $16,129 in first half, nothing in the second half, and get any credit. To prevent manipulation of the credit, the wages paid to a qualified employee during the last 26 weeks of such period must equal at least 80% of such wages for the first 26 weeks.

> **Comment.** In other words, the employer can't work a person for six months, keep them on payroll for one hour in the last six months, and get any credit.

> **Example.** If Solar Chariot paid a worker $8,960.56 the first 26 weeks, and $7,168.44 in the second 26 weeks, which is 80% of the first 26 weeks, Solar Chariot would still get the $1,000 credit in 2011.

The entire $1,000 credit is lost if the new hiree leaves for any reason in the first 52 consecutive weeks. If a new hiree voluntarily leaves after 50 consecutive weeks, the employer is not eligible for *any* HIRE credit for that hiree! The new hiree must stay on the job for the entire 52 weeks and these weeks need to be consecutive.

Recordkeeping. Because the determination of a qualified employee must be done during the recruiting and hiring process and separate qualifications exist for the 6.2% OASDI payroll tax exemption and the $1,000 income tax credit, businesses need to incorporate the following administrative processes:

- Document eligibility and insure the employee's affidavit is properly completed and retained,
- Determine qualified wages each deposit period and quarterly, and
- Track retention and qualified wages of each qualified employee.