THE ELITE QUARTERLY

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RENEW YOUR SUBSCRIPTION NOW FOR 2009 & SAVE WITH OUR EARLY SUBSCRIBER DISCOUNT

As we approach the end of the year, we want to wish you a Happy Holiday season and a happy and productive 2009. Thank you for your business and helpful suggestions. This is our final newsletter for 2008. There were four quarterly newsletters for 2008 (Volume XVII Number 1 - Volume XVII Number 4). If you did not receive all four newsletters, please call us at 1-800-950-0273, and we will mail you any missing issues. **We are taking subscriptions now for our 2009 newsletters ($115 for customers subscribing early). By subscribing, you save $37 ($47 if you subscribe by February 15, 2009) over the cost of the four quarterly newsletters and 2 hours of ethics if you do not subscribe.** Please visit our website at www.cpelite.com regularly, as new developments that our company makes first are reported at our website. Here are the items in this issue of the newsletter:

1. **Congressional Action** (pages 1-3) in the passage of the Emergency Economic Stabilization Act of 2008.

2. **IRS Rulings and Other Items** (pages 3-7), including a revenue procedure allowing both parents in a divorce or separation situation to take advantage of certain provisions related to benefits provided to their children, and several items which provide guidance on recent tax legislation.

3. **Court Decisions** (pages 7-12), including whether a surviving spouse may elect to file a joint return for delinquent tax returns and a case demonstrating the dangers of litigating a case without an attorney.

4. **Treasury Regulations** (pages 12-13), one dealing with health savings accounts and one dealing with information reporting for stock options.

5. **An Elite Possibility** (pages 13-14) involving year-end tax planning and whether it is prudent to claim the Section 179 immediate expense deduction and bonus depreciation in 2008.

6. **Quiz Questions (**pages 15-16).

7. **Enrolled Agent CPE Information** (page 19).

8. **Newsletter and Subscription Information** (page 19), providing two options for using our newsletter for CPE credit.

9. **CPA and Licensed Accountant Self-Study CPE Information** (page 19).

10. **Course Information** (pages 19-20).

LEARNING OBJECTIVE AND CONTENT LEVEL — The primary learning objective of this newsletter is to make accounting and tax practitioners aware of recent legislation, IRS rulings and other items, court decisions, and Treasury regulations likely to have an impact on most tax practices. The content level of the newsletter material is an overview of these items.

PREREQUISITES — There are no prerequisites nor is advance preparation required for our newsletters.

4444444444444 CONGRESS 444444444444444

CONGRESS PASSES THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008 (EESA '08). While the major purpose of the law is to help troubled financial institutions to the tune of $700 billion, nearly 300 changes to the Internal Revenue Code were made to help assure passage of the so-called "bailout bill." An analysis of several provisions which are likely to have significant tax effects on many of your clients in 2008 is provided below.

Tax Provisions Affecting Individuals

Alternative Minimum Tax (AMT) – As in the last few years, the AMT exemption amounts have increased: (1) $69,950 for married individuals filing a joint return and surviving spouses; (2) $46,200 for other unmarried individuals; and, (3) $34,975 for married individuals filing separate returns. Without these extended increases, the amounts for 2008 would have been considerably lower (for example, only $45,000 for joint returns). The law also allows individuals to offset their entire regular tax liability and AMT liability by the nonrefundable personal credits. One of the harshest provisions of the AMT has been the adjustment related to the exercise of an incentive stock option. The EESA '08 provides that any underpayment of tax outstanding on the date of enactment which is attributable to the application of the AMT adjustment for incentive stock options (including any interest or penalty relating thereto) is abated.

Casualty and Disaster Losses – There may be some tax relief for families that were victimized by natural disasters in 2008 if their damaged property was underinsured. For a "net disaster loss" incurred between January 1, 2008, and December 31, 2011, the 10% AGI limitation does not apply. A "net disaster loss" is defined as the excess of personal casualty losses attributable to a "Federally declared disaster" occurring

in a "disaster area" over personal casualty gains. The term "Federally declared disaster" means any disaster subsequently determined by the President to warrant Federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The term "disaster area" means the area so determined to warrant assistance. For taxpayers who do not itemize their deductions, their standard deduction is increased by the "net disaster loss." The Committee reports provide the following example to illustrate this new provision:

> An individual taxpayer with $100,000 of adjusted gross income has the following personal casualty items during the taxable year: $5,000 personal casualty gain, $30,000 allowable personal casualty loss attributable to a Federally declared disaster, and a $12,000 allowable personal casualty loss. The taxpayer's deductible net personal casualty loss for the taxable year is $27,000 (the sum of the net disaster loss of $25,000 ($30,000 - $5,000) and $2,000 (the excess of the other casualty losses over the 10-percent limitation)). **Note:** If it is more favorable to claim the standard deduction, the standard deduction is increased by $25,000 in this case.

On the negative side, the $100 limitation per casualty is increased to $500 for taxable years 2009 - 2011. This seems harsh for taxpayers suffering a non-disaster casualty loss as this loss is already reduced by the 10% AGI limitation.

Child Credit – The child credit ($1,000 per child under the age of 17) may be refundable if it exceeds the taxpayer's tax liability. The refundable credit is limited to 15% of earned income in excess of a threshold dollar amount. Effective for taxable years beginning in 2009, the threshold is reduced from $12,050 to $8,500.

Extensions – Several provisions affecting individual income taxpayers have been extended through 2009 unless otherwise specified. Some of the most common provisions include the following:

1. The state and local sales tax deduction in lieu of the state and local income tax deduction.

2. The $250 above-the-line deduction for eligible educator expenses.

3. The additional standard deduction for state and local property taxes for individuals who do not itemize their deductions (up to $1,000 for joint filers and $500 for single filers). You may not be familiar with this provision, as it only recently was added by the "Housing and Recovery Act of 2008."

4. The income exclusion for individuals aged 70 ½ or older who distribute up to $100,000 of their IRA balance to a qualified charitable organization. The distribution also does not result in a charitable deduction.

Tax Provisions Affecting Businesses

Disaster-Related Provisions – As for individuals, the EESA '08 provides tax relief for businesses affected by natural disasters. For a net operating loss (NOL) attributable to a qualified disaster loss incurred between January 1, 2008, and December 31, 2011, the NOL may be carried back five years rather than two years. The amount of the carryback is limited to the corporation's overall NOL. Another provision allows a taxpayer to elect to deduct certain capital expenditures related to disaster losses (labeled "qualified disaster expense") as a deduction in the year paid or incurred. A "qualified disaster expense" is a capitalizable expenditure paid or incurred in connection with a trade or business that is: (1) for the abatement or control of hazardous substances that were released on account of a Federally declared disaster; (2) for the removal of debris from, or the demolition of structures on, real property damaged or destroyed as a result of a Federally declared disaster; or, (3) for the repair of business-related property damaged as a result of a Federally declared disaster. The effective date is the same as that for the preceding provision dealing with the NOL.

Executive Compensation Deduction – The deduction for compensation paid to the chief executive of a publicly-held corporation and its four most highly compensated officers is $1,000,000 per employee per year. This limitation does not apply to performance-based compensation. The EESA '08 reduces this limitation to $500,000 for compensation paid by an "applicable employer" to the chief executive of the company and its three most highly compensated officers. "Applicable employer" is defined as any employer from which one or more troubled assets are acquired by the Treasury Department under the "troubled assets relief program" if the aggregate assets acquired exceed $300 million. An "applicable employer" under this provision is not limited to publicly held corporations (or even limited to corporations).

Tax Preparer Penalty – With respect to the definition of unreasonable position under the tax preparer penalty provisions, the EESA '08 changes the threshold to the "substantial authority" standard. The "substantial authority" standard is less stringent than the recently added "more likely than not" standard that it replaces, but greater than the former "realistic possibility" standard. **Notes**: (1) This change now means that rules covering tax preparer penalties and taxpayer penalties for substantial understatement of income tax use the same standard of "substantial authority." (2) For tax shelters, the "more likely than not" threshold is retained.

****REVIEW QUESTIONS AND SOLUTIONS****

True False Questions

1. As a result of the EESA '08, the maximum compensation deduction paid by "applicable employers" to the company's chief executive is $1,000,000.

Multiple Choice Questions

2. **Which one** of the following **is not** a benefit provided in the EESA '08?

    a. A taxpayer who suffers a personal "net disaster loss" may increase her standard deduction by the amount of the loss.

    b. The portion of the child credit which qualifies as a refundable credit has been lowered.

    c. Businesses which incur costs for capital expenditures related to business property damaged as a result of a Federally declared disaster may elect to deduct the expenditures in the year paid or incurred.

3. As a result of the EESA '08, what is the AMT exemption amount for joint returns in 2008?

    a. $45,000.
    b. $46,200.
    c. $69,950.

Solutions

1. **False is the correct response.** The EESA '08 lowered the maximum compensation deduction paid to the company's chief executive to $500,000 if the Treasury Department, pursuant to the troubled assets relief program, acquires more than $300 million of the company's assets.

    True is the incorrect response. The $1,000,000 limitation is the current limitation that applies to compensation paid to all chief executives of publicly-held corporations (unless limited by the provision covering the "troubled assets relief program"). *Emergency Economic Stabilization Act of 2008 (EESA '08).*

2. **"B" is the correct response**. The threshold for the refundable portion of the child credit was lowered from $12,050 to $8,500. Since the refundable portion of the child credit is 15% of the earned income in excess of the threshold, the lower the threshold, the greater the credit.

    "A" is an incorrect response. For taxpayers who otherwise would claim a standard deduction, if a "net disaster loss" had not been incurred, the EESA '08 allows the standard deduction to be increased by the amount of the "net disaster loss."

    "C" is an incorrect response. The EESA '08 provides three categories of capital expenditures related to disaster losses for which a taxpayer may elect to deduct the expenditures in the year paid or incurred. Business property damaged as a result of a Federally declared disaster is the third category. *EESA '08*.

3. **"C" is the correct response**. As Congress has been doing for several years, the EESA '08 provides a "patch" to the AMT by increasing the AMT exemption amounts. For 2008, the exemption amount for taxpayers filing jointly is $69,950.

    "A" is an incorrect response. $45,000 would be the exemption amount for taxpayers filing jointly if Congress did not extend the AMT "patch."

    "B" is an incorrect response. $46,200 is the 2008 exemption amount for unmarried taxpayers. *EESA '08*.

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CHILD MAY BE DEPENDENT OF BOTH PARENTS IN CERTAIN INSTANCES

2004 and 2005 legislation provide that, for post-2004 tax years, generally a child of divorced parents may be treated as the dependent of the noncustodial parent only if the custodial parent releases the claim to the exemption. In the absence of a release, the child is the dependent of the parent for whom the child is either a "qualifying child" or a "qualifying relative." Revenue Procedure 2008-48 [8/18/08] provides a limited exception to these rules. With respect to certain provisions, a child is the dependent of both parents whether or not the custodial parent releases the claim to the exemption. The provisions include the medical expense deduction for a taxpayer's child (Section 213) and the following four gross income exclusions: (1) certain employer reimbursements of expenses incurred for a child's medical care (Section 105); (2) employer contributions to an accident or health plan on behalf of the employee's children (Section 106); (3) no-additional-cost services or qualified employee discounts treated as used by the employee due to use by an employee's child (Section 132); and, (4) Archer MSA and HSA distributions used to pay qualified medical expenses of the account beneficiary's child (Sections 220 and 223). The procedure applies to a child of parents who are divorced, separated, or living apart, when the custodial parent has not released the claim to the exemption for the child per Section 152(e)(2). **Planning Pointer:** Though the procedure is effective August 18, 2008, taxpayers may apply the procedure in any tax year that begins after December 31, 2004, for which the return still is open.

IRS PROVIDES GUIDANCE ON 2008 IMMEDIATE EXPENSE DEDUCTION

In Revenue Procedure 2008-54 [8/29/08], the IRS provides guidance on the immediate expense deduction, which was increased by the Economic Stimulus Act of 2008 (ESA '08). For qualified property (Section 179 property) placed into service during 2008, the amount of the deduction nearly doubles from $128,000 to $250,000. The amount of the deduction is reduced by each dollar of Section 179 property purchased in excess of $800,000 (prior amount was $510,000). The IRS explains the affect of this change on pass-through entities (partnerships and S corporations) and property

acquired in certain states recently victimized by natural disasters(GO Zone – Gulf Opportunity Zone property – and Kansas disaster area property). For pass-through entities with a taxable year beginning in 2008 and ending in 2009, the increased limitation applies to Section 179 property placed into service during the entity's 2008-2009 taxable year. This is problematic for entities owned by majority owners. The IRS illustrates the tax consequences of this situation in an example that has the following facts: (1) an S Corporation has a taxable year beginning April 1, 2008, and ending March 31, 2009; (2) the S Corporation is owned 100% by one individual who reports on the calendar year; and, (3) the S Corporation purchases its only Section 179 property for the year on April 18, 2008, for $250,000. Because the property was placed into service during the taxable year beginning in 2008, the S Corporation may claim up to $250,000 in Section 179 immediate expense deductions. However, the sole shareholder cannot claim his share (100% in this case) of the S Corporation's Section 179 deduction until 2009. If no other changes are made between now and the end of 2009, the most the shareholder could claim is $128,000 (plus any potential inflation adjustment for 2009). For certain GO Zone and Kansas disaster area property acquired in 2008, the immediate expense deduction is increased by $100,000 and the phaseout base is increased by $600,000. As a result of the ESA '08, the IRS clarifies that the maximum Section 179 deduction and phaseout base for property acquired and used in these areas during 2008 are $350,000 and $1,400,000, respectively. The Elite Possibility considers tax planning for the Section 179 deduction and bonus depreciation in 2008.

IRS PROVIDES GENEROUS TRANSITION RULE FOR QUALIFIED RESERVIST DISTRIBUTIONS FROM A HEALTH FSA

The major advantage of a health flexible spending arrangement (FSA) is to pay for medical costs not covered by the taxpayer's insurance plan with "before-tax" wages. The amount to be contributed to an employee's FSA has to be determined in advance and paid in over the applicable calendar year. The major disadvantage of a health FSA is that unused contributions remaining at the end of the plan year (or at the end of a grace period, if applicable) are forfeited under the so-called "use it or lose it" rule. Consider an army reservist who sets aside $2,000 to his health FSA for 2008 only to be called to duty for a one-year period beginning in early 2008. If the army provides for all of the soldier's medical care while the soldier is serving his or her country, any unused contributions to the health FSA could be lost. This seemingly unfair result was remedied by one of the provisions of the Heroes Earnings Assistance and Relief Tax of 2008, which provides a special rule allowing distributions of unused amounts in a health FSA to reservists ordered or called to active duty. In Notice 2008-32 [9/29/08], the IRS provides guidance on this new provision. The decision of whether to allow a qualified reservist distribution (QRD) from a health FSA is optional for the employer. Generally, a QRD may not be made before the cafeteria plan is amended to provide for a QRD from a health FSA. However, the notice provides a transition rule which allows a plan to be amended retroactively to permit QRDs requested on or before December 31, 2009. The retroactive amendment must be made by December 31, 2009, and be effective retroactively to the date of the first QRD paid under the plan, but not prior to June 18, 2008. In order to qualify for this provision, the reservist must be called to active duty for a period of 180 days or more or for an indefinite period. If the plan does not specify the amount available as a QRD, then the amount available shall be the amount contributed to the health FSA as of the date of the QRD request minus health FSA reimbursements received as of the date of the QRD request. **Note:** While this provision prevents the reservist from losing his unspent contribution, the QRD is included in the gross income and wages of the employee, and is subject to employment taxes.

IRS PROVIDES GUIDANCE ON NEW HOMEBUYER CREDIT

In the Fall 2008 issue of *The Elite Quarterly*, we reported that one of the major tax provisions of the "Housing and Recovery Act of 2008" is the new tax credit for first-time homebuyers. The good news is that the credit could be as high as $7,500 if the home purchase costs $75,000 or more (it is limited to 10% of the purchase price of the home). The bad news is that it has to be "paid back" over 15 years in equal annual installments beginning with the second tax year after the year the credit is claimed. Essentially, this credit amounts to an "interest-free loan." For example, if a first-time homebuyer purchases a home for $100,000 in 2008, she receives a $7,500 "loan" in the form of a tax credit, and beginning in 2010 she will "pay back" $500 per year in the form of an extra tax. In IRS News Release IR-2008-106 [9/16/08], the IRS provides guidance as to several questions concerning this provision. The credit is a refundable credit and is available for purchases after April 8, 2008, and before July 1, 2009. The credit may not be taken in the following situations: (1) the taxpayer buys the home from a close relative, including the taxpayer's spouse, parent, grandparent, child, or grandchild; (2) the taxpayer's income exceeds the phase-out range (modified AGI (MAGI) of $170,000 for joint filers and MAGI of $95,000 for other taxpayers – a partial credit is available for MAGIs between $150,000 - $170,000 for joint filers, $75,000 - $95,000 for other taxpayers); (3) the taxpayer is a nonresident alien; (4) the taxpayer is or was eligible to claim the Washington, D.C. first-time homebuyer credit for any taxable year; and, (5) the purchase of the home was funded from tax-exempt mortgage revenue bonds. Taxpayers who owned a main home at any time during the three years prior to the date of purchase are not eligible for the credit. In addition, vacation homes and rental property are not eligible. If the taxpayer sells the home, dies, or otherwise stops using the home as her principal residence, all remaining payments are due on the return for the year that the event happens. However, if the taxpayer transfers the home to the former spouse pursuant to a divorce decree, the former spouse is responsible for making all subsequent installment payments.

IRS CONSIDERS WHETHER SAME PROPERTY CAN BE USED IN TWO DEFERRED LIKE-KIND EXCHANGES

In a deferred like-kind exchange, the date the replacement property is acquired is not the same as the date the relinquished property is transferred. There are two general types of deferred like-kind exchanges – (1) forward, and (2) reverse. In a forward like-kind exchange, the taxpayer's relinquished property is transferred to the buyer (either directly or indirectly through a qualified intermediary) before the replacement property is acquired. Once the property is transferred, the taxpayer has to meet the following two deadlines: (1) within 45 days of the transfer, the taxpayer must identify one or more potential *replacement properties*, and (2) within 180 days of the transfer, the taxpayer must acquire one or more of the *replacement properties*. In a reverse like-kind exchange, the replacement property is acquired ("parked" with an accommodation titleholder) before the relinquished property is transferred. As in the case of a forward like-kind exchange, in order to qualify for tax-deferred treatment, the taxpayer must meet two similar deadlines: (1) within 45 days of the acquisition of the replacement property (ies), the taxpayer must identify one or more potential *relinquished properties*, and (2) within 180 days of the transfer, the taxpayer must transfer one or more of the *relinquished properties* to a buyer (either directly or indirectly through a qualified intermediary). In Chief Counsel Advice 200836024, the taxpayer engaged in a reverse like-kind exchange where he acquired replacement property. While he identified the relinquished property within the 45-day period, the value of the relinquished property was far in excess of the value of the replacement property. Rather than receive cash at the closing, which would result in substantial gain, the taxpayer wished to defer the remaining gain on the transfer of the relinquished property by engaging in a forward exchange (acquiring additional replacement property after the transfer of the relinquished property to a qualified intermediary). The issue in the ruling is whether the relinquished property could be used to qualify for like-kind exchange treatment in both of the deferred exchanges. The IRS first considered whether the taxpayer's proposed transactions violated Congressional intent because there could be up to 360 days between the acquisition of the first replacement property (in the reverse exchange) and the acquisition of the second replacement property (in the forward exchange). It concluded that they did not violate Congressional intent as there were two distinct exchanges. Because neither Section 1031, the applicable regulations, nor a previous revenue procedure which provides guidance on deferred exchanges expressly prohibits the use of the same relinquished property for two deferred exchanges, the IRS permitted the proposed arrangement.

IRS PROPOSES TO INCREASE REQUIRED DISCLOSURE FOR GROUPED PASSIVE ACTIVITIES

In Notice 2008-64 [8/4/08], the IRS proposes to require taxpayers to report for purposes of the passive activity loss rules their original groupings and regroupings of passive activities, as well as any addition or disposition of specific activities within their existing grouping of passive activities. Taxpayers would be required to file a written statement with the return for the tax year in which (1) trade or business or rental activities are originally grouped as a single activity or as separate activities, (2) a new trade or business activity or rental activity is added to an existing grouping, (3) there is a disposition of a specific activity from an existing grouping, and, (4) activities are regrouped from their original grouping. In all of the instances, the taxpayer must identify the names, addresses, and EINs of the trade or business or rental activities affected. The IRS's proposal would not be effective until final guidance is published. Taxpayers would not be required to file a written statement for groupings existing at the time final guidance is issued. If a taxpayer failed to properly report activities as required under the proposed guidance, each trade or business or rental activity would be treated as having been grouped as a separate activity.

REVIEW QUESTIONS AND SOLUTIONS

True False Questions

4. For 2008, the noncustodial parent of a divorced child may be permitted to claim a gross income exclusion for an HSA distribution that the parent uses to pay the child's qualified medical expenses, even though the custodial parent has not released the dependency exemption to the noncustodial parent.

Multiple Choice Questions

5. Regarding recent IRS guidance on the Section 179 immediate expense deduction, **which one** of the following statements **is true**?

   a. A solely-owned S Corporation, which begins its fiscal year in 2008, may claim up to $250,000 in Section 179 immediate expense deductions even though its year end falls in 2009.

   b. If a solely owned S Corporation, which begins its fiscal year on July 1, 2008, claims the maximum allowable Section 179 immediate expense deduction, the shareholder will be able to claim the full amount of the deduction on his or her individual return in 2009.

   c. For certain GO Zone and Kansas disaster property acquired in 2008, the immediate expense deduction equals $600,000.

6. Under the new provision dealing with a qualified reservist distribution (QRD), **which one** of the following statements **is true**?

   a. The QRD may **not** exceed 50% of the unused balance in the employee's health FSA.

b. The QRD is **not** subject to employment taxes.

c. An employer is **not** required to amend the provisions of the company's health FSA to include QRDs.

7. Regarding the new homebuyer credit, **which one** of the following statements **is false**?

   a. Taxpayers who own a home during the five years prior to the date of the new home purchase is **not** eligible to claim the credit.

   b. If the taxpayer purchases a home in 2008, claims the homebuyer credit in 2008, and sells the home in 2015, the balance of the unpaid amounts related to the 2008 homebuyer credit will be due on the 2015 tax return.

   c. A single taxpayer with modified AGI of $100,000 buys her first home in 2008. She is **not** eligible to claim the homebuyer credit.

8. Regarding the deferred like-kind exchange provisions, **which one** of the following statements **is true**?

   a. In a forward like-kind exchange, the taxpayer purchases replacement property before he transfers his relinquished property.

   b. The IRS ruled that it is possible to use the same replacement property in two like-kind exchanges.

   c. In a reverse like-kind exchange, the taxpayer must transfer his relinquished property within 180 days after the replacement property is acquired.

9. Based on a recent IRS notice, **which one** of the following is a taxpayer **not required** to provide for a trade or business or rental activity that she disposes of from an existing grouping during the tax year?

   a. The address of the activity.

   b. The EIN of the activity.

   c. The number of employees who work full-time in the activity.

Solutions

4. **True is the correct response.** The IRS recently provided that, for the medical deduction and four fringe benefit income exclusion provisions, a child will be treated as the dependent of both parents who are divorced, even though the custodial parent has not released the dependency exemption for the child to the noncustodial parent. One of the provisions is the gross income exclusion provision for such HSA distributions.

   False is the incorrect response. The exclusion for an HSA distribution used to pay a child's qualified medical expenses now is available for the noncustodial parent, even though the custodial parent has not released the dependency exemption for the child. *Revenue Procedure 2008-48*.

5. **"A" is the correct response**. Because the S Corporation's fiscal year begins in 2008, the IRS indicates that the $250,000 Section 179 immediate expense deduction applies to Section 179 property placed into service during the entity's 2008-2009 taxable year.

   "B" is an incorrect response. Even though the S Corporation may claim the full $250,000, the ruling limits the S Corporation shareholder's share of the deduction to the 2009 amount, which will be $128,000 plus any inflation adjustments for 2009.

   "C" is an incorrect response. The immediate expense deduction for certain GO Zone and Kansas disaster property acquired in 2008 is $350,000 ($250,000 + $100,000). $600,000 is the increase in the phaseout base amount. *Revenue Procedure 2008-54*.

6. **"C" is the correct response**. The new law related to QRDs does not require employers to include a provision for a QRD in its health FSA.

   "A" is an incorrect response. If the health FSA does not specify the amount of the QRD, it equals the remaining balance at the time of the QRD request.

   "B" is an incorrect response. While the new law prevents the reservist from losing his unspent contribution, the QRD is included in the gross income and wages of the employee, and it is subject to employment taxes. *Notice 2008-32*.

7. **"A" is the correct response**. The new homebuyer credit is not available to taxpayers who owned another home during within the last three years, not five years.

   "B" is an incorrect response. The new homebuyer credit is "paid back" interest free over 15 years. If the taxpayer stops using the home as his or her principal residence, all remaining payments are due on the return for the year that the event happens.

   "C" is an incorrect response. For single taxpayers, the homebuyer credit is phased out once the taxpayer's modified AGI reaches $95,000. *IRS News Release IR*-2008-106.

8. **"C" is the correct response**. There are two deadlines applicable to reverse like-kind exchanges. The second deadline requires the transfer of the taxpayer's relinquished property within 180 days after the replacement property is acquired.

"A" is an incorrect response. Response A describes a reverse like-kind exchange, not a forward like-kind exchange.

"B" is an incorrect response. Although it may be possible to use the same **replacement** property in two like-kind exchanges, the ruling addressed whether the same **relinquished** property could be used in two like-kind exchanges. *Chief Counsel Advice 200836024.*

9. **"C" is the correct response.** In a recent notice, the IRS proposes to require that, basically whenever a grouping of a taxpayer's passive activities is affected, the taxpayer provide specific information for the affected trade or business or rental activity: the number of employees who work full-time in the activity is not one of them.

   "A" is an incorrect response. The address of the activity is one of the items the IRS would require.

   "B" is an incorrect response. The EIN of the activity is another one of the items that the IRS would require. *Notice 2008-64.*

4444444444 **COURT DECISIONS** 4444444444

TAXPAYER ALLOWED TO FILE JOINT RETURN FOR LATE RETURNS FILED AFTER SPOUSE'S DEATH

In Vadalier [8/29/08], the taxpayer's spouse died in 2005. Pursuant to filing a Chapter 13 petition in 2006, the taxpayer filed his 2005 tax return along with delinquent income tax returns for the taxable years 2000 - 2004. On each of these returns, he claimed "married filing jointly" filing status even though he failed to report his wife's income earned during 2000 through 2004. The IRS determined that he was able to file a joint return in 2005, the year of death, but not in any of the previous years. Its argument is based on IRC Section 6013(a)(3), which states in part "the joint return may be made by the surviving spouse with respect to both himself and the decedent if no return for the ***taxable year*** (emphasis added) has been made by the decedent, and no executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse" (including extensions). The IRS (and Bankruptcy Court which ruled against the taxpayer) argued that the singular use of "taxable year" implies that the surviving spouse can elect to file a joint return only in the year of death of the decedent. The IRS also noted that an example in the Treasury regulations under Section 6013 implies that at most a surviving spouse may make a joint return for himself and his deceased spouse for two taxable years if his spouse died after the end of one taxable year but before the return for that year was due. On the other hand, the taxpayer argued that "taxable year" refers to the year under analysis rather then the year of death. A district court held for the taxpayer. It noted that the requirements for joint return filing status are as follows: (1) neither spouse was a nonresident alien and both spouses had the same taxable years (calendar years) in 2000 through 2004; (2) no return for the taxable years 2000 through 2004 had been made by the decedent; and, (3) no executor or administrator was appointed before the last day prescribed by law for filing the return of the surviving spouse. Since there were no returns made by the decedent for any of the years at issue, and there was no authorized representative for the decedent's estate, the district court ruled that the taxpayer was entitled to make joint returns for 2000-2004 on behalf of himself and his decedent spouse. The court was particularly persuaded by a transcript which provided evidence of the decedent spouse's intent to file joint returns with her spouse so that they could become current with the IRS. She had engaged a tax attorney in 2004 to negotiate tax payment installments with the IRS and was working on the 2004 tax return before she passed away.

DOCTORS' BOLD CONTRIBUTION STRATEGY BLOCKED AND PENALTIES APPLY

The Tax Court recently agreed with the IRS, where it foiled a strategy by medical personal service corporation (PSC) owners to take a substantial charitable contribution for stock in the PSC that they donated to a tax-exempt PSC. Additionally, the court upheld substantial penalties imposed on the doctors in the PSC. The doctors practiced anesthesiology as employees and stockholders of a medical PSC that specialized in anesthesiology. They were employed by the PSC on month-to-month contracts that did not include noncompete clauses. Their PSC was one of a number of medical practice specialty groups affiliated with a university hospital which provided services to the hospital and clinics and whose owners also taught as members of the hospital's teaching faculty. Because of risk and management issues, the university decided that it wanted all of the groups to consolidate into a single medical practice group that was controlled and managed by a single PSC, which in turn would be under the university's direct management and administration. Under the plan, those not merging would not continue affiliation with the university, and those merging were to leave their separate medical practice specialty groups and PSCs and become employees of the new blanket tax-exempt PSC. Under a strategy developed by a related CPA, the doctors planned to donate their PSC stock to the new PSC and take a substantial charitable contribution deduction for the donated stock. They engaged an attorney to effect the details, and retained an appraiser to value the donated stock, in line with the plan devised by the CPA. The appraiser placed a value of $401.79 per share on the 440 shares of donated stock, resulting in a $176,787 deduction. The taxpayer's PSC was the only one of the consolidating specialty groups which donated stock to the new tax-exempt PSC. The transferee PSC accepted the donation "as a professional courtesy," and valued the stock at $0, based on the transferring PSC's winding up its affairs within a year of the donation. In Bergquist and Kendrick, et al. [7/22/08], the Tax Court in a regular decision noted that a charitable contribution should be valued on the valuation date on the basis of market conditions and facts available on that date without regard to hindsight.

It stated that, in deciding valuation issues, trial courts often consider the opinions of expert witnesses. The principal point of disagreement between the IRS's and the taxpayer's appraiser's valuations was going concern value: the court stated that, at the time of donation, the PSC should not be valued as a going concern. The IRS asserted that neither an income nor market approach should be used to value the stock but, instead, an asset-based approach should be used. Further, the IRS asserted that lack of control and marketability discounts should be applied. The court agreed, and upheld a $37 per share amount for voting stock donated, and $35 for nonvoting stock donated. Further, the court upheld accuracy-related penalties for gross valuation misstatement and/or negligence. The court felt that the taxpayers had not made a good faith investigation as to the value of the stock, and that they did not act in good faith – they relied on advice based on an unreasonable assumption (business would continue) that they knew or should have known was not likely to be true.

IRS DENIED SUMMARY JUDGMENT IN CASE INVOLVING SECTION 530 RELIEF

In Porter [8/4/08], an Iowa district court considered the IRS's request for summary judgment against the taxpayer in an employment tax case. The court stated its reluctance to approve summary judgment, noting the nonmoving party (taxpayer here) should be given the benefit of all reasonable inferences, and all facts should be viewed in the light most favorable to the nonmoving party. The taxpayer manufactured and sold livestock products. For 1996 and 1997, he had treated his salesmen as independent contractors. The IRS insisted that the salesmen were employees, and withholding and payroll taxes for them should have been borne by the taxpayer. The court considered the applicable 20 common law factors in Revenue Ruling 87-41 to ascertain if the taxpayer had exercised sufficient control to establish an employer-employee relationship. Factors supporting independent contractor status were salesmen (1) had no set territory, and (2) were able to set their own work schedules. Factors supporting employee status were: (1) employer paid for salesmen's business expenses, (2) lack of salesmen investment in facilities used in performing their work, (3) employer right to discharge the salesmen, and (4) employee right to end employment at any time. The court found four inconclusive factors. The court sided with the IRS that the salesmen were not properly classified as independent contractors, and that an employer-employee relationship existed. Then the court considered if the employer met the safe harbor requirements of Section 530 of the 1978 Revenue Act for employers who have misclassified their workers and failed to properly withhold employment taxes. The court examined each of the 3 essential requirements of Section 530: (1) taxpayer files requisite Federal tax returns on a consistent basis treating the individuals as independent contractors (reporting consistency requirement); (2) taxpayer treats all persons holding substantially similar positions as independent contractors (substantive consistency requirement); and, (3) taxpayer has reasonable basis for treating the individuals as independent contractors (reasonable basis requirement). As to requirement one, the court found that there was a genuine issue of material fact as to whether Form 1099s were filed in 1996, and whether Form 1096s were filed for either 1996 or 1997. As to requirement two, the court found no evidence to indicate that the taxpayer had classified the salesmen differently from one another for employment tax reporting purposes. As to requirement three, the court noted that the taxpayer had relied on his long-time attorney in preparing his employment tax returns, and it stated that the advice of counsel and other professional advisors qualifies as technical advice, meeting the reasonable basis requirement. Though the attorney was deceased at the time of trial, the court felt that the taxpayer had relied on the advisor's technical advice, and believed that summary judgment on the reasonable basis requirement was not appropriate. Viewing the record in a manner most favorable to the taxpayer, the court denied the IRS's request for summary judgment.

TAXPAYER LOSES ON BASIS AND EXPENSE DEDUCTION ISSUES

In Cook [7/30/08], the Tax Court considered if the IRS's assertions that the taxpayer was required to use a zero basis for stock sold, and that the taxpayer was denied certain expenses related to a rental home should be upheld. The taxpayer filed his 2003 return, in response to an IRS deficiency notice, on April 6, 2007. The taxpayer said that he had filed an extension on Form 4868, but he had no approved copy from the IRS as support; so, the court did not receive the taxpayer's copy of Form 4868 as evidence in the trial. With respect to the taxpayer's sale of stock, the IRS assigned a zero basis to the stock, and hence all of the sales proceeds were treated as capital gain. The taxpayer asserted that his stock basis was $3,400.72, and that he had a long-term capital loss on the sale. In that the taxpayer had not met the conditions of IRC Section 7491(a) to shift the burden of proof to the IRS, the court held that the burden of proof remained with the taxpayer. The court also cited case law that permitted the IRS to proceed with its own independent calculation when the taxpayer has failed to file a return. The taxpayer failed to provide evidence to substantiate his stock basis, and so the court upheld the zero basis assigned by the IRS to the stock sale. One of the expenses the IRS and court denied for the taxpayer's rental activity was a legal fee paid with respect to the towing of his car. He kept the car adjacent to his rental property so that he could use it to take care of the property when he was there. He had a feud with the homeowner's association about the car's being parked near the rental property, the association had the car towed, and the taxpayer incurred a legal fee in suing the association. The court used the "origin-of-the-claim" rule, and examined the facts and circumstances to ascertain if the legal fee were a deductible expense associated with the rental activity, noting that the expense had to be "proximately related to the rental activity." The court noted that the following items must be considered: (1) the issues, (2) the action's nature and objectives, (3) the defenses asserted, (4) the purpose for the legal fees, and (5) the background of the litigation. It found that the legal fee was personal and not deductible. **Planning Pointer:** The taxpayer represented himself before the court, and sought to call a local broker as a witness to testify as to his stock basis. However, because he did not comply with the court's

rules or the Federal rules of evidence or procedure, the court did not permit the witness to be called.

MARK-TO-MARKET ELECTION NOT AVAILABLE AND TRADING LOSSES NOT ORDINARY LOSSES FOR INVESTORS

The taxpayer and his wife bought and sold stocks as agents for their LLC in 5 trading accounts they maintained. They traded out of their home. For the LLC's first year in 2001, a short year of 8 ½ months, they executed 289 trades. For 2002, they executed 372 trades. They timely made a mark-to-market election under IRC Section 475(f), which applies to securities traders (do not deal with customers like a dealer), to treat realized gains and losses as recognized at the end of the year, and to claim ordinary treatment for realized and recognized gains and losses. They claimed ordinary losses of $180,174 in 2001, and $45,521 in 2002. In Holsinger [8/11/08], the Tax Court noted that the Section 475(f) election is available only to those engaged in a trade or business as traders in securities, a term distinguished from investors in securities. It stated that there are 3 nonexclusive factors to consider in determining if one is a trader: (1) taxpayer intent; (2) nature of income to be derived from the activity; and, (3) frequency, extent, and regularity of the taxpayer's securities transactions. It further noted that the trading activity must be substantial, in contrast to being sporadic. The court stated that substantial means "frequent, regular, and continuous enough to constitute a trade or business." It delineated 2 specific requirements the taxpayer must meet for his activities to be a trade or business: (1) the taxpayer's trading is substantial; and, (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments. As to the first requirement, the court considered the number of trades the taxpayers made in a year. It found the taxpayers traded on less than 40% of the trading days in 2001, and less than 45% in 2002: it concluded that trading activity was not substantial, and not conducted with the frequency, continuity, and regularity indicative of a business. As to the second requirement, the court found that the documentary evidence showed they rarely bought and sold on the same day, and a significant amount of their holdings were held for more than 31 days: it concluded that the taxpayers did not seek to capture the daily swings in the market. It held that the taxpayers were investors, not traders engaged in a trade or business. Accordingly, stock gains and losses were capital – the capital loss limitations applied – and expenses they incurred with respect to the activity were not deductible as business expenses, but instead deductible as investment expenses.

TENTH CIRCUIT DENIES TAXPAYER LIFO METHOD FOR STOCK SOLD AND BAD DEBT DEDUCTION FOR LOAN TO DISTRESSED CORPORATION

The taxpayer was one of two founding shareholders and chief executive officer and board chairman of a public corporation. The corporation's business activity was researching and developing a process to extract bitumen from oil sands and converting it to synthetic crude oil. The corporation acquired oil-shale leases in Canada, and sought to raise capital to construct a plant there. To help, the taxpayer loaned money to the corporation with funds he obtained through a margin account with his broker. He pledged 2,660,000 shares of stock in his company to obtain the line of credit with his broker. The pledge agreement specified that the loans were payable to his broker on demand. About 2 months after the pledge, the broker demanded repayment of the loan. The taxpayer did not repay the loan. The broker sold 634,100 of the shares to satisfy the debt, and returned to the taxpayer a single stock certificate representing the taxpayer's remaining shares. After the broker called the loan, the taxpayer's corporation had difficulty obtaining the necessary financing for the plant, and it was "mothballed." The company filed for Chapter 11 bankruptcy later that year. During bankruptcy proceedings, the corporation sold its interest in leases and oil production facilities in Canada, though it retained its interest in certain technologies, some patents, and other assets. The company's unaudited financial statements at the end of the year showed assets exceeding liabilities by about 81%, and its stock going from being delisted on the NASDAQ to being traded over the counter. The taxpayer argued that the broker's sale of the pledged stock was not taxable to him and, if so, he could compute his stock basis for the sale using the LIFO method. Further, the taxpayer argued he was entitled to a bad debt deduction for the loan that he made to his company. In Rendall [8/5/08], the 10th Circuit agreed with the Tax Court on all issues. It noted that the terms of the pledge agreement gave the broker an unrestricted right to demand payment at any time to satisfy the taxpayer's debt to the broker. His refusal to repay the loan supported the broker's right to sell enough shares to satisfy the debt. Further, in that the taxpayer had not specifically identified the shares that the broker was to sell, he was not permitted to use the LIFO method to identify the shares sold, but instead was required to use the FIFO method to identify the basis in the shares sold. As to the taxpayer's claim to take a bad debt deduction for the loan he made to his corporation, the 10th Circuit stated that filing for bankruptcy was not alone indicative that the debt had become worthless. It noted that the taxpayer agreed that the corporation was not insolvent, and though the corporation had an agreement to sell substantial operating assets and leases, it still retained ownership over numerous technologies, patents, office space, a research facility, and land, and continued to employ a team of engineers. The taxpayer failed to convince the court that at the end of the tax year there was no reasonable hope of recovery on the loan he had made to his corporation. Thus, he was not entitled to a bad debt deduction.

NONBUSINESS INVESTOR DENIED INVESTMENT SEMINAR DEDUCTIONS

Though the law seems clear on the issue of an investor deducting seminar expenses, the Tax Court in a regular decision [Jones and Serrato; 7/28/08] recently considered the issue. The taxpayer was a Florida resident who drove 750 miles to attend an intensive 5-day, 37-hour seminar in Georgia to improve his day trading abilities. He acted reasonably, for example, not engaging in recreational activities during the course, and staying in a modest hotel near where the seminar was

held. He claimed $6,053.06 of course and related expenses as miscellaneous itemized deductions to attend the seminar. He conceded that he was not in the trade or business of day trading. The court noted that the taxpayer, having not shifted the burden of proof for claiming the deductions to the IRS under IRC Section 7491(a), bore the burden of proof for claiming the deductions: deductions are a matter of legislative grace. The court observed that, while it had permitted similar deductions in a 1983 case, 1986 legislation specifically overruled that decision by adding IRC Section 274(h)(7). Section 274(h)(7) disallows deductions for taxpayers for expenses allocable to conventions, seminars, or similar meetings, where the meeting is with respect to an investment activity, not a trade or business. The court held that the course the taxpayer attended was a seminar, and since his activity was an investment activity, the seminar expenses he incurred could not be deducted. **Planning Pointer:** The expenses would be deductible under IRC Section 162, subject to other limitations, e.g., the 50% limit on meal and entertainment expense, were the taxpayer in the trade or business of day trading.

IRS CONTINUES TO LITIGATE FICA TAX LIABILITY WITH RESPECT TO MEDICAL RESIDENCY PROGRAMS

Over the years, we have reported several cases dealing with the issue of whether stipends made to medical students during their residency program are subject to FICA taxes. In Center for Family Medicine and University of South Dakota School of Medicine Residency Corporation [8/6/08], two separate residency programs operated 36 months of training and elective rotations. While the programs were not identical, each program required the residents to attend daily conferences and rounds designed to provide educational opportunities and to attend a minimum percentage (50% in one program, 60% in the other) of lectures and presentations conducted by the faculty. Throughout the three-year program, the residents are provided written and oral evaluations and after the completion of the program they are provided certificates of completion which allow them to take the applicable medicine board examination. The two taxpayers filed a complaint seeking a refund of FICA taxes paid on the stipends given to their medical residents for the nine taxable years 1995-2003 on the basis that stipends are exempt from FICA taxes under the "student exception." To qualify for this exception there are two general requirements. First, the service must be performed in the employ of either a school, college, or university, or a Section 509(a)(3) organization operated exclusively to perform the functions of, or to carry out the purposes of, a school, college, or university. Second, the service must be performed by a student who is enrolled and regularly attending classes at such school, college, or university. On the basis of a 1998 Eighth Circuit case, the district court noted that for the student exception to apply, it must be shown that the work performed by the residents is "incident to and for the purpose of pursuing a course of study." The taxpayer argued the residency programs were the employers for the following reasons: (1) the residency programs reviewed applications and ranked the residents for purposes of the match program; (2) incoming residents entered into contracts directly with the residency programs; (3) the residency programs controlled the course of the residents' work through requiring the completion of specific rotations; and, (4) the residency programs determined the residents' ability to advance and had the ability to discipline or ultimately discharge the residents. The IRS considered the hospitals to be the employer for the following reasons: (1) the hospitals have an ability to influence application selection, and retain control over the residents through the enforcement of hospital bylaws and rules; (2) the residents served under the immediate control of physicians at those hospitals; and, (3) the residents provided services beneficial to the provider hospitals. The district court made three major findings. First, it found the residency programs to be the employers principally because the residency programs controlled the manner in which the residents performed under their contract and had the primary authority to discipline residents. Additionally, both programs required that all physicians who supervised residents were members of the residency program faculty, which gave the residency programs direct control over the daily activities of the residents while they were at the provider hospitals. Second, it had no problem finding that the residency programs qualified as schools. Third, it held the residents were regularly attending classes when they attended the daily conferences, participated in patient care, which is part of their course of study, and participated in rounds and other interaction at the direction of residency program faculty. As a result of these findings it held that the stipends paid to the medical residents satisfied the student exception which exempts the stipends from FICA taxes.

REVIEW QUESTIONS AND SOLUTIONS

True False Questions

10. In a recent case involving PSC owners who donated their stock to a tax-exempt PSC in exchange for an interest in the tax-exempt PSC, the owners were able to avoid the accuracy-related penalty for gross valuation misstatement because they had relied on the advice of a CPA, attorney, and appraiser.

11. In a recent case involving stipends paid to medical students during their residency programs, the court held that the stipends are **not** subject to FICA taxes.

Multiple Choice Questions

12. Assume the following: (1) the taxpayer and his spouse filed jointly on their 2006 tax return; (2) the taxpayer's spouse dies on December 30, 2008; (3) on April 15, 2009, the taxpayer files tax returns for 2007 and 2008; and, (4) an administrator other than the taxpayer is appointed for the decedent spouse's estate on November 1, 2009. On the basis of a recent court case, in which years can the taxpayer alone (without the administrator's approval) elect to file as married filing jointly?

    a. Both 2007 and 2008.

    b. Only 2007.

    c. Only 2008.

13. Recently, a court decided that a company had improperly classified its salesmen as independent contractors. Factors the court felt favored employee status were all of the following **except**:

    a. Salesmen had no set territory.

    b. Company paid for the salesmen's business expenses.

    c. Lack of salesmen investment in facilities they used in performing their work.

14. With respect to a recent Tax Court case involving the proper amount of gain (loss) that a taxpayer should report on a stock sale and whether a legal fee was deductible, **which one** of the following statements **is false**?

    a. Since the taxpayer was representing himself before the court, he was excused from complying with the Tax Court's rules.

    b. The taxpayer failed to meet the conditions of IRC Section 7491(a), and so the burden of proof remained with the taxpayer.

    c. The court used the "origin-of-the-claim" rule to determine if the legal fees were proximately related to the taxpayer's rental activity.

15. The Tax Court recently held that a husband and wife who made many stock trades were investors, not traders engaged in a trade or business. **Which one** of the following **was** an item in the case?

    a. The court concluded that they were seeking to catch the swings in daily market movements and to profit from such short-term changes.

    b. They were able to treat their stock gains and losses as ordinary gains and losses.

    c. The court concluded that trading on less than 45% of the days in the year was not substantial trading.

16. In a recent court case, why was the taxpayer not permitted to use the LIFO method to identify the shares of stock that he sold?

    a. The LIFO method may not be used to identify the basis of shares sold.

    b. The broker sold the shares due to a pledge agreement that the taxpayer had with the broker.

    c. He did not specifically identify the shares of stock that his broker was to sell.

17. In **which one** of the following cases will the taxpayer **be permitted** a deduction for expenses incurred to attend an investment seminar?

    a. The seminar expenses are incurred with respect to her day trading business.

    b. The seminar expenses are incurred with respect to her day trading investing activity, and the taxpayer acting reasonably with respect to the expenses that she incurred.

    c. The seminar expenses are incurred with respect to her day trading investing activity, and the seminar she attends is a focused, intensive seminar dealing only with improving day trading activities.

Solutions

10. **False is the correct response.** The taxpayers' reliance on a CPA, attorney, and appraiser notwithstanding, the Tax Court felt that the taxpayers had not made a good faith investigation as to the value of the stock, and upheld IRS application of accuracy-related penalties for gross valuation misstatement and/or negligence.

    True is the incorrect response. The Tax Court stated that the taxpayers had relied on professional advice that was based on an unreasonable assumption that the business would continue, an assumption they knew or should have known was not likely to be true. *Bergquist and Kendrick, et al.*.

11. **True is the correct response.** Because the court found the three items in the following list, it ruled the stipends were exempt from FICA taxes: (1) the employers of the residents were the residency programs; (2) the residency programs were considered schools; and, (3) the residents were regularly attending classes.

    False is the incorrect response. The stipends would be subject to FICA taxes if one of the three requirements discussed above is not satisfied. *Center for Family Medicine and University of South Dakota School of Medicine Residency Corporation.*

12. **"A" is the correct response**. One of the requirements for allowing a surviving spouse to file a joint return is that no executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse. In this case, the appointment was made after the due date of the 2008 return so the taxpayer may elect to file married jointly for both 2007 and 2008.

    "B" is an incorrect response. Only 2007 would have been correct if the administrator had been appointed by October 15, 2009, the last day prescribed by law to timely file the 2008 tax return.

    "C" is an incorrect response. Only 2008 would have been correct if IRC Section 6013 applies only to the taxable year in which the spouse died. The court ruled that it applies to all years in which tax returns had not yet been filed. *Vadalier.*

13. **"A" is the correct response.** One of the two factors the court felt favored classification of the salesmen as independent contractors was that the salesmen had no set territory.

"B" is an incorrect response. The court identified 4 factors it felt had established an employer-employee relationship. Company payment of the salesmen's business expenses is factor #1.

"C" is an incorrect response. The lack of salesmen investment in facilities they used in performing their work is the second employer-employee factor. *Porter.*

14. **"A" is the correct response.** The taxpayer was not permitted by the court to call a local broker as a witness to testify as to his stock basis because he failed to comply with the court's rules or the Federal rules of evidence or procedure, a failure attributable to his representing himself and not being familiar with the rules.

    "B" is an incorrect response. Generally, the burden of proof rests with the taxpayer. However, if the taxpayer meets the conditions of IRC Section 7491(a), the taxpayer is able to shift the burden of proof to the IRS in any court proceeding: the taxpayer did not meet the required conditions.

    "C" is an incorrect response. The court used the "origin-of-the-claim" rule, examining the facts and circumstances and considering 5 items to determine if the legal fees were a nondeductible personal expense or a deductible rental activity expenses. *Cook.*

15. **"C" is the correct response.** The court stated that the taxpayers must meet 2 specific requirements for their trading activities to be a trade or business. One of the requirements is that their trading be substantial. The court concluded that, since their trading was done on less than 40% of the trading days in 2001, and less than 45% in 2002, their trading was not conducted with the frequency, continuity, and regularity indicative of a business, and thus it was not substantial.

    "A" is an incorrect response. To the contrary: the court concluded that, since a significant amount of the taxpayers' stock holdings were held for more than 31 days, they were **not** seeking to catch the swings in daily market movements and to profit from such short-term changes.

    "B" is an incorrect response. Also to the contrary: because the court held that the taxpayers were investors, they were required to treat their stock gains and losses as capital, not ordinary, gains and losses. *Holsinger.*

16. **"C" is the correct response.** The 10th Circuit required that the taxpayer use the FIFO method to identify the basis in the shares that his broker sold because he had not specifically identified the shares that his broker was to sell.

    "A" is an incorrect response. While the FIFO method must be used where the taxpayer does not specifically identify the shares sold, the LIFO method may be used if the shares that are sold are specifically identified.

    "B" is an incorrect response. It was the taxpayer's failure to identify the shares sold, not the fact that they were sold by the broker due to a pledge agreement, that resulted in the FIFO method's having to be used to identify the shares that were sold. *Rendall.*

17. **"A" is the correct response.** In a recent case, the Tax Court denied the taxpayer a deduction for investment seminar expenses because Section 274(h)(7) specifically forbids a deduction for seminar expenses for an investor. Such expenses would be deductible were the taxpayer in the trade or business of day trading.

    "B" is an incorrect response. Though the taxpayer did not engage in recreational activities during the seminar course and stayed in a modest hotel near where the seminar was held, his seminar expenses still were denied because his day trading activity was an investment activity.

    "C" is an incorrect response. It did not matter that the investment seminar the taxpayer attended was an intensive 5-day, 37-hour seminar: the taxpayer's day trading activity was an investment activity, not a trade or business activity, and a deduction was not permitted. *Jones and Serrato.*

44444444444444 **TREASURY** 44444444444444

PROPOSED REGULATIONS GIVE MORE GUIDANCE ON HEALTH SAVINGS ACCOUNTS

REG-120476-07 [7/17/08] states that employer contributions to the Health Savings Accounts (HSAs) of nonhighly compensated employees (NHCEs) may be larger than employer contributions to the HSAs of HCEs with comparable coverage. However, contributions to the HSAs of HCEs may not exceed those made to the HSAs of NHCEs with comparable coverage. An HCE is one who either (1) is a 5% owner at any time during the current or preceding year, or (2) for the preceding year, (A) had compensation from the employer in excess of $105,000 (2008 indexed amount), and (B) if use of the preceding year is elected by the employer, was in the group consisting of the top 20% of employees when ranked based on compensation. There is an HSA special rule for individuals who are eligible for HSA contributions during the last month of the taxable year: those individuals may make or have made on their behalf the maximum annual HSA contribution based on their high deductible health plan (HDHP) coverage (self only or family) on the first day of the last month. The regulations state that the employer can contribute up to this maximum contribution for all employees who are eligible individuals during the last month of the taxable year, including employees who become eligible after January 1 of the calendar year and eligible individuals who were hired after January of the calendar year. In this case, the employer will not fail to make comparable contributions merely because some employees will have received more contributions on a monthly basis than employees who worked the entire calendar year. The regulations also address a "qualified HSA distribution" (certain direct distributions from a health flexible spending arrangement or a health reimbursement

arrangement) to an HSA. They specify that if an employer offers qualified HSA distributions to any employee who is an eligible individual covered under any HDHP, the employer must offer qualified HSA distributions to all employees who are eligible individuals covered under any HDHP. But, an employer that offers qualified HSA distributions only to employees who are eligible individuals covered under the employer's HDHP is not required to offer qualified HSA distributions to employees who are eligible individuals but are not covered under the employer's HDHP.

TREASURY UPDATES INFORMATION REPORTING FOR STOCK OPTIONS

In REG-103146-08 [7/17/08], the IRS issues proposed regulations on information returns required from employers when they issue stock pursuant to an employee's exercise of an incentive stock option (ISO) or under an employee stock purchase plan. With respect to the information where an ISO is exercised, the information return contains the same information as before, with one exception: instead of the employer's reporting the total cost of all shares acquired by the employee upon the ISO exercise, the IRS now requires that exercise price per share be reported. The information must be provided on Form 3921, and it must be filed with the IRS and a copy provided any affected employee on or before January 31 of the year following the calendar year for which the return is made. With respect to the information where stock is issued under an employee stock purchase plan, additional new information is required by the IRS: (1) date option was granted to transferor; (2) fair market value of stock on date option was granted; (3) exercise price per share; (4) date option was exercised by transferor; and, (5) fair market value of stock on date option was exercised by transferor. The information must be provided to the IRS and any affected employee on Form 3922, also on or before January 31. **Compliance Pointer:** Though the regulations are proposed to apply to any stock transfer that occurs on or after January 1, 2007, corporations are excused from complying with the return requirements for stock transfers that occur during the 2007 and 2008 calendar years. However, corporations must furnish information statements to employees for such 2007 and 2008 stock transfers.

REVIEW QUESTIONS AND SOLUTIONS

True False Questions

18. In assessing the comparability of contributions that an employer makes to employee HSAs, an employee who owns a 10% interest in the business in the preceding year is treated as a highly compensated employee.

Multiple Choice Questions

19. For 2009, a corporation issues its shares of stock to an employee who exercises incentive stock options for the corporation's shares. Based on recent proposed IRS regulations, what information return must the corporation provide the IRS?
    a. Form 3921.
    b. No form is required for 2009.
    c. Form 3922.

Solutions

18. **True is the correct response.** One of the definitions of a highly compensated employee for purposes of assessing the comparability of employer contributions to employee HSAs is that the employee is a 5% owner at any time during the preceding year.

    False is the incorrect response. Employees must be categorized between highly compensated and nonhighly compensated, as employer contributions to their HSAs must meet certain regulatory rules based on this distinction. One rule is based on employee ownership in the company: a highly compensated employee is one who is a 5% owner at any time during the current or preceding year. *REG-120476-07*.

19. **"A" is the correct response.** Form 3921 must be provided the IRS and a copy provided the employee on or before January 31, 2010.

    "B" is an incorrect response. Only for stock transfers made by a corporation with respect to the exercise of employee incentive stock options or under employee stock purchase plans that occur during the 2007 and 2008 calendar years is the corporation excused from filing Form 3921 with the IRS.

    "C" is an incorrect response. The corporation provides the IRS with Form 3922 if its stock shares are issued under an employee stock purchase plan. *REG -103146-08*.

44444444 AN ELITE POSSIBILITY 444444444

The expansion of the Section 179 immediate expense deduction and the addition of bonus depreciation are tempting provisions to take advantage of in 2008. For example, consider a small business who purchases $300,000 of 5-year recovery property and $500,000 of 10-year recovery property during 2008. If the company wanted to maximize its deductions, it would claim (1) $250,000 of immediate expense deductions against the 10-year recovery property, 50% bonus depreciation for the 5-year recovery property ($150,000) and the remaining balance of the 10-year recovery property ($125,000) and MACRS on the remaining balances of the 5-year ($30,000) and 10-year ($12,500) recovery properties. The total deductions for the two properties equal $567,500 or nearly 71% of the cost of the two properties. If the company's net income before these deductions is $600,000, should all of the above deductions be taken in 2008? As in the case of general year-end tax planning involving deduction timing, taxpayers need to examine their current marginal tax rates and to project their future estimated tax rates before a decision is reached.

Back to our example, if the company is incorporated, claiming all of the deductions would result in taxable

income of $32,500 ($600,000 - $567,500), which means $17,500 of deductions ($50,000 - $32,500) would have saved taxes at only a 15% rate and another $25,000 of deductions (between $50,000 and $75,000 of corporate taxable income) would have saved taxes at a 25% rate. The corporation should consider choosing the straight-line method for the balance of the deductions (this would reduce the deductions by $21,250) or reduce the immediate expense deduction which, when combined with the other deductions, would bring corporate taxable income to $75,000 rather than $32,500.

If the company is a closely-held pass-through entity, the company and its tax advisers need to examine the owners' other sources of income and deductions. For example, if the company were owned only by one individual and the company's income represented the individual's only source of income, many of the deductions might be at relatively low marginal tax rates. Another consideration is whether the income is subject to self-employment tax.

With the upcoming change in administration of our executive office, there are many unanswered questions making year-end planning particularly difficult this year. Will there be a tax cut or a tax increase next year or in the near future? Will the FICA cap on self-employment income be lifted? Will the 2001 law changes be made permanent? Depending on what happens, taxpayers may regret claiming deductions in 2008 that they could have deducted in future years. Section 179 provides a remedy that bonus depreciation does not. Specifically, bonus depreciation must be claimed unless a taxpayer makes an election out of the provision. Once made, an election out cannot be revoked without IRS consent. On the other hand, the Section 179 deduction is elective and can be revoked without the consent of the IRS for property placed into service through 2010 (the revocation is irrevocable). If the taxpayer chooses not to claim the Section 179 deduction in 2008, the regulations permit taxpayers to "make an election" on an amended return without the IRS consent. In other words, there is considerably more flexibility for the Section 179 deduction than for the bonus depreciation deduction. Therefore, bonus depreciation should not be claimed in 2008 until the potential benefits and costs are studied carefully.

REVIEW QUESTIONS AND SOLUTIONS

Multiple Choice Questions

20. If a taxpayer has property eligible for both the Section 179 immediate expense deduction and bonus depreciation in 2008, **which one** of the following statements **is false**?

    a. If the taxpayer is uncertain about the direction of future income tax rates and wants to defer some deductions to future years, it would be better to claim bonus depreciation in 2008 rather than the Section 179 expense deduction.

    b. In calculating the total deduction for eligible property purchased in 2008, bonus depreciation is calculated before the amount of the Section 179 expense deduction is determined.

    c. If a Schedule C taxpayer expects to be in the 15% marginal tax rate in 2008 because of current market declines, but expects her business to improve significantly in 2009, it may be prudent to elect out of bonus depreciation.

Solutions

20. **"B" is the correct response**. The Section 179 immediate expense deduction is computed before bonus depreciation is determined.

    "A" is an incorrect response. Unlike for the Section 179 immediate expense election, the decision to claim or not claim bonus depreciation is not revocable. If the taxpayer only wants to claim one of the deductions, it would be better to claim bonus depreciation. If it appears in future years it would have been better to also claim the Section 179 immediate expense deduction, the taxpayer may do so by filing an amended return.

    "C" is an incorrect response. If the taxpayer will be in a higher tax bracket in future years, it will be better to defer depreciation deductions to those years. *An Elite Possibility.*

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***** QUIZ QUESTIONS *****

*Place your answers to the following 5 True-False Questions and 15 Multiple Choice Questions on the enclosed answer sheet (**page 17**).*

TRUE-FALSE QUESTIONS

1. The deduction for state and local sales taxes in lieu of the deduction for state and local income taxes is **not** available for 2008 individual income tax returns.

2. A taxpayer engages in a reverse like-kind exchange beginning on December 1, 2007, and engages in a forward like-kind exchange beginning on March, 6, 2008. It is possible to use the same relinquished property for both like-kind exchanges.

3. Based on a recent IRS notice, a taxpayer would be required to file a written statement for a tax year in which the taxpayer disposed of a specific passive activity from an existing passive activity grouping.

4. In a recent court case, a taxpayer who filed late returns for 2000 - 2004 was able to file a joint return in 2005, the year his spouse died, but had to file married separately for years 2000 - 2004.

5. In 2009, a calendar-year corporation issues stock to an individual employee who exercises incentive stock options. The corporation must provide the employee with certain information regarding the exercise by March 15, 2010.

MULTIPLE CHOICE QUESTIONS

6. Based on the Emergency Economic Stabilization Act of 2008, **which one** of the following statements **is true** for 2008 tax returns?

   a. Any nonrefundable tax credits that reduce the regular income tax liability also may reduce the alternative minimum tax liability.

   b. A net operating loss attributable to a qualified disaster loss may be carried back up to three years.

   c. With respect to the definition of unreasonable position under the tax preparer penalty provisions, the threshold has been reduced from "more likely than not" to "realistic possibility."

7. A taxpayer has two **personal** casualty losses for 2008. Before the AGI limitation, the amount of the casualty losses are $15,000 for loss #1 and $8,000 for loss #2. Loss #1 resulted from a Federally declared disaster while Loss #2 resulted from a car accident unrelated to a Federally declared disaster. If the taxpayer's AGI is $100,000, what is the net casualty loss deduction claimed as an itemized deduction?

   a. $23,000.
   b. $15,000.
   c. $13,000.

8. A recent IRS revenue procedure provides that in five instances a child will be treated as the child of a non-custodial divorced parent even though the custodial parent has not released the exemption claim to the child. **Which one** of the following **is not** one of those instances?

   a. Gross income exclusion for employer contributions to an accident or health plan on behalf of an employee's child.

   b. Medical expense deduction for a taxpayer's child.

   c. Child tax credit for a taxpayer's child.

9. Taxpayer A is a 100% shareholder in the XYZ Corporation, an S Corporation. XYZ's year end for tax purposes is January 31. For the period 2/1/08 - 1/31/09, it purchases $400,000 of qualified Section 179 property. Assume the following: (1) for 2009, there are no inflation adjustments made to the Section 179 expense deduction; (2) Taxpayer A makes no Section 179 property purchases in 2008 and 2009; and, (3) the S Corporation and Taxpayer A wish to maximize their Section 179 expense deductions in 2008 and 2009. How much of the Section 179 immediate expense deduction claimed by the XYZ Corporation may Shareholder A deduct on his 2008 and 2009 tax returns?

   a. 2008 – $229,166.67; 2009 – $20,833.33.
   b. 2008 – $-0-; 2009 – $250,000.
   c. 2008 – $-0-; 2009 – $128,000.

10. Regarding a qualified reservist distribution (QRD), **which one** of the following statements **is false**?

    a. The QRD is included in the gross income and wages of the employee.

    b. If the provision is to apply retroactively, the amendment to the company's health flexible spending arrangement plan must be made by December 31, 2009.

    c. The reservist must be called to active duty for a period of at least one year.

11. In **which one** of the following circumstances may a single taxpayer claim the homebuyer tax credit?

    a. The taxpayer with a modified AGI of $50,000 buys the home from the her father.

    b. The taxpayer with a modified AGI of $70,000 buys the home from an unrelated person.

    c. The taxpayer, a nonresident alien with a modified AGI of $60,000, buys the home from an unrelated person.

12. PSC owners contribute stock to their PSC (old PSC), taking an initial basis of $5 per share. Years later, the owners donate their stock to a new tax-exempt PSC in exchange for shares in the new PSC, shortly after which their old PSC goes out of business. At the time of the stock donation to the new PSC, the old PSC stock has a going concern value of $200 per share, and a value of $75 per share based on the value of the PSC's assets less lack of control and marketability discounts. Based on a recent court decision, what is the value per share assigned to the donated shares?

    a. $75.
    b. $5.
    c. $200.

13. **Which one** of the following **is not** a requirement for a company to obtain Section 530 relief for failure to properly withhold employment taxes?

    a. The company consistently files tax returns treating the workers as **independent contractors**.

    b. The company has consistently treated the workers as **employees**.

    c. The company has a reasonable basis for treating the workers as **independent contractors**.

14. In a recent case in which the court applied the "origin-of-the-claim" rule to determine if a legal fee the taxpayer incurred was related to his rental activity, the court noted that 5 items must be considered in making the determination. **Which one** of the following **was not** one of those items?

    a. The nature and objectives of the action taken by the taxpayer.

    b. The taxpayer had filed his return late, and he did not have an approved copy of Form 4868.

    c. The background of the litigation.

15. A taxpayer is a trader in the business of trading securities. He makes an IRC Section 475(f) mark-to-market election for the securities he owns and sells. During the tax year he sells securities at a net $50,000 gain. At the end of the year, his securities inventory has an aggregate basis of $175,000 and fair market value of $100,000. How much gain (loss) does the taxpayer report for the year, and what is its character?

    a. $50,000 capital gain.
    b. $25,000 ordinary loss.
    c. $50,000 ordinary gain.

16. Recently, the 10th Circuit denied the taxpayer a bad debt deduction for money that he had loaned a corporation he had founded. With respect to the court's decision to deny the deduction, **which one** of the following statements **is false**?

    a. The court felt that the corporation's filing for bankruptcy was not alone indicative that the loan had become worthless.

    b. The court denied the deduction because the taxpayer was the corporation's chief executive officer.

    c. The court still was solvent at the end of the tax year for which the taxpayer claimed the deduction.

17. Assume a taxpayer who trades stocks is treated as an investor. The taxpayer attends an intensive out-of-town day-trading seminar to learn how to improve his trading abilities. He incurs $5,000 of expenses ($500 is for meals) related to attending the seminar. How much may the taxpayer deduct?

    a. $4,750.
    b. $0.
    c. $5,000.

18. Regarding whether a medical resident's stipends are exempt from FICA taxes in a recent court case, **which one** of the following statements **is true**?

    a. The medical residents are considered to be "attending classes" when they attend daily conferences and participate in patient care.

    b. If the hospitals are considered to be the employer, the stipends they make are exempt from FICA taxes.

    c. A factor against the taxpayer in the case is that less than 50% of the physicians that the residents work under are not associated with the residency programs.

19. With respect to proposed regulations on employer contributions to health savings accounts (HSAs), **which one** of the following statements **is false**?

    a. If an employer offers qualified HSA distributions to any employee who is an eligible individual covered under any high deductible health plan (HDHP), the employer must offer qualified HSA distributions to all employees who are eligible individuals covered under any HDHP.

    b. Employer contributions to the HSAs of nonhighly compensated employees may exceed those made to the HSAs of highly compensated employees.

    c. Employer contributions to the HSAs of highly compensated employees may exceed those made to the HSAs of nonhighly compensated employees.

20. For 2008, the taxpayer is considering claiming the maximum amounts for the Section 179 immediate expense deduction and bonus depreciation deduction. **Which one** of the following statements may be a correct reason for **not** claiming one or both of the deductions in 2008?

    a. The Section 179 election is **not** revocable.

    b. If bonus depreciation is claimed in 2008, it may be revoked before the statute of limitations expires out.

    c. The tax rates after 2008 are expected to increase.

CPElite T.M. Inc.
THE ELITE QUARTERLY NEWSLETTER

QUIZ INSTRUCTIONS AND ANSWER SHEET – WINTER 2008, VOLUME XVII, NUMBER 4
(Latest Recommended Completion Date: Within one year of purchase)

There are 20 quiz questions. The quiz questions are on pages 15-16 of the newsletter. Choose the best answer based on the limited facts of each question, and record your answer below. Indicate your responses in the newsletter for your personal records and **complete the "Newsletter Evaluation" below.**

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[1] INCOME ITEMS AND PROPERTY TRANSACTIONS -- Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) selected income items affecting individual income taxpayers, including social security income, alimony, scholarships, and court awards, and (2) common property transactions involving individual income taxpayers, such as capital gains, sale of personal residence, and like-kind exchanges.

[2] ABOVE-THE-LINE DEDUCTIONS -- Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) reduction in gross income for expenses commonly deducted by Schedule C taxpayers, including travel, transportation, and home office deductions, and (2) and other above-the-line deductions claimed by many individual income taxpayers.

[3] ITEMIZED DEDUCTIONS – Recommended CPE Credit: 6 HRS [B]

To provide an explanation of medical expenses, taxes, qualified residence interest, charitable contributions, nonbusiness casualty and theft losses, and both categories of miscellaneous itemized deductions, as well as the standard deduction.

[4] RATES, CREDITS AGAINST TAX, AND SPECIAL ISSUES – Recommended CPE Credit: 6 HRS [B]

To provide an explanation of the tax rate structure, selected credits (including the earned income tax credit and the education credits), estimated tax payments, and selected special issues (including filing status, exemptions, and provisions that are phased out for high-income taxpayers).

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THE ELITE QUARTERLY NEWSLETTER

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(See Page 19)

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