THE ELITE QUARTERLY – Taxation

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We hope that you had a successful 2018 filing season. Many of you have renewed your newsletter subscriptions, we thank you very much! See pages 22 and 23 for details of all of our subscription packages. Testing online at our website is more convenient than ever. Thank you for being a customer – we appreciate your business! Here are the items in this newsletter.

What's Inside This Issue

INSTRUCTIONS – Read the content on pages 1-17, the quiz questions on pages 18-20, and the quiz instructions on page 21. Select the best answer for each quiz question and record the answers either on the answer sheet on page 21 or on-line at www.cpelite.com.

COURSE COMPONENTS, CONTENT LEVEL, AND LEARNING OBJECTIVES

The components of this newsletter are divided in order among IRS rulings, court decisions, a Treasury item dealing with recent TIGTA findings regarding the reporting for employee identity theft victims, Special Topics covering cancellation of debt income and disposing an interest in real estate rental property held as a co-owner versus as an LLC member in an LLC taxed as a partnership, and *An Elite Possibility* dealing with an estate's "portability election." The content level of the newsletter is an update of these items. For the IRS items, the learning objectives are: (1) Compute how much of a taxpayer's home equity loan qualifies as acquisition debt; (2) Know who the IRS's "Withholding Calculator" may benefit; (3) Recognize employers who may benefit from the Work Opportunity Tax Credit; (4) Know the rules which qualify armed forces members in the Sinai Peninsula to claim combat zone benefits; (5) Determine the maximum depreciation deductions for various years for vehicles placed into service in 2018; (6) Identify items on the IRS's list of 2018 "Dirty Dozen" tax scams; (7) Know key items about the IRS's "Offshore Voluntary Disclosure Program"; (8) Recognize general principles that apply to virtual currency transactions; and, (9) Know recent inflation-adjusted amounts updated for the Tax Cuts and Jobs Act of 2017. For each court ruling, the learning objectives are: (1) Differentiate the taxpayer's

argument from the IRS's position; (2) Identify the factors used in the court's decision; and, (3) Recognize the decision reached by the court. For the Treasury item, the learning objective is: Know the TIGTA audit findings for employee identity theft victims. For the Special Topics sections, the learning objectives are: (1) Recognize the fundamental issues and know the federal income tax consequences of those issues with respect to debt cancellation income, and (2) Differentiate between certain tax consequences of disposing of an interest in real estate rental property held as a co-owner versus as an LLC member in an LLC taxed as a partnership. The learning objective for the Elite Possibility is: Know whether the Code, treasury regulations, and a recent court decision allow a personal representative of the decedent's estate to elect or not elect the portability election.

Key Terms in This Issue of THE ELITE QUARTERLY

[Item 2] Withholding Calculator: At www.irs.gov, an electronic calculator that taxpayers may use to verify the accuracy of their withholding.

[Item 3] Work Opportunity Tax Credit: A credit available to businesses based on a part of a worker's wages during the first two years of employment. Only certain categories of workers qualify. The credit is part of the general business credit.

[Item 4] Combat pay: Tax-free additional compensation paid to m embers of the arm ed forces who are on active duty in a designated com bat zone or hazardous duty area.

[Item 6] Dirty Dozen: Com piled annually by the IRS, a list of the twelve tax scams of which the IRS feels taxpayers need to be aware.

[Item 7] Offshore Voluntary Disclosure Program: An IRS program that encourages taxpayers with back taxes, interest, and penalties stemming from foreign financial assets to com e forward and settle those obligations. The program offers those taxpayers protection from criminal liability and term s for resolving their civil tax and penalty obligations.

[Item 8] Virtual currency: Virtual currency generally is a digital representation of value that functions in the same manner as a country's traditional currency.

[Item 9] Blended rate: A method to calculate the income tax liability of fiscal corporations where part of the year's income is taxed at the old rate and the remaining part of the year's income is taxed at the new rate.

[Item 12] Section 1234A: A seldom -used provision that provides for capital gain tax treatment on the receipt of a nonrefundable deposit from a terminated sale of capital asset property.

[Item 13] "Gain" ("Loss") basis: Different bases used to calculate if there is a gain (taxpayer's basis in the property) or loss (fair market value of the property when personal-use property is converted to business use) on property when it later is sold after having been converted to business use.

[Item 15] Employment identity theft: Occurs when an identity thief uses another person's identity to gain employment, causing potential tax issues to the victim.

[Item 16] Insolvency exclusion: One of the provisions that enables a taxpayer who has cancellation of debt income to exclude part or all of the income from gross income. Insolvency is the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets immediately before the discharge.

[Item 17] Nominee: A person or company whose name is given as having title to a stock, real estate, etc., but who is not the actual owner.

[Item 19] DSUE: Deceased spouse's unused exemption. It equals the unified credit (currently $11.18 million) less the decedent's estate tax.

[Item 19] Portability election: An election by the personal representative of a decedent's estate which allows the surviving spouse's estate to use the DSUE when the first spouse dies.

IRS

[ITEM 1] IRS CLARIFIES 2018 INTEREST DEDUCTION ON HOME EQUITY LOANS

The "Tax Cuts and Jobs Act" of 2017 (TCJA '17) suspends from 2018 until 2026 the deduction for interest paid on home equity loans and lines of credit. In the 2018 Spring issue of *The Elite Quarterly*, we noted that acquisition debt includes debt proceeds used for "**substantial"** home improvements, so home equity loan interest attributable to home improvements should be deductible in 2018. Since there was some question on this issue, the IRS in IR-2018-32 [2/21/18] provides guidance on the deductibility of interest on home equity debt in 2018. The IRS notes that interest on a home equity loan used to build an addition to an existing home is typically deductible, while interest on the same loan used to pay personal living expenses, such as credit card debts, is not. Section 163(h)(3)(B)(I), which defines acquisition indebtedness, requires (1) that the debt is secured by the residence, and (2) the proceeds are used to construct or substantially improve a qualified residence. A qualified residence includes the taxpayer's principal residence and a second home such as a vacation home. If a home equity loan is used to purchase or make substantial improvements on a qualified residence, the residence which is being purchased or improved must be the security on the loan. The IRS provides two examples to clarify this matter.

Example 1: A taxpayer takes out a $500,000 mortgage in January 2018 to purchase a main home with a fair market value of $800,000. In February 2018, the taxpayer takes out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the main home and the total debt does not exceed the cost of the home. Because the total debt does not exceed $750,000 (the maximum amount of qualified acquisition debt in 2018), all of the interest paid on the loans is deductible. However, if the taxpayer used the home equity loan proceeds for personal expenses, such as paying off student loans and credit cards, then the interest on the home equity loan would not be deductible.

Example 2: A taxpayer takes out a $500,000 mortgage in January 2018 to purchase a main home. The loan is secured by the main home. In February 2018, the taxpayer takes out a $250,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages does not exceed $750,000, all of the interest paid on both mortgages is deductible. However, if the taxpayer took out a$250,000 home equity loan on the main home to purchase the vacation home, then the interest on the home equity loan would not be deductible. ***Note:*** *As Example 2 illustrates, the tax cost could be significant if the taxpayer secured the wrong home when taking out a home equity loan to purchase or improve a qualified residence.*

[ITEM 2] TAXPAYERS SHOULD CHECK IRS'S WITHHOLDING CALCULATOR

The 2017 TCJA '17 made many changes affecting individual taxpayers in 2018. In IR-2018-80 [4/5/18], the IRS urges many individual taxpayers to use its "Withholding Calculator" (WC) at www.irs.gov/withholding to estimate their 2018 income tax to ensure that 2018 withholdings are as accurate as possible, and to minimize surprises when 2018 returns are filed. It points up that with average refunds topping $2,800, some taxpayers might prefer to reduce 2018 withholding. The TCJA '17 changes increasing the standard deduction, removing the personal exemptions, increasing the child tax credit, limiting or discontinuing certain deductions, and changing the tax rates and brackets make assessing current withholding more necessary than usual. The IRS specifies certain groups who in particular should check their withholding, namely those who: (1) belong to a two-income family; (2) work two or more jobs or only work for part of the year; (3) have children and claim credits such as the Child Tax Credit; (4) have older dependents, including children age 17 or older; (5) itemized deductions on their 2017 tax returns; (6) earn high incomes and have more complex tax returns; and, (7) received large tax refunds or had large tax bills for 2017. It points out that taxpayers should have their 2017 tax return and most recent pay stubs available when they use the WC. Also, the IRS reminds taxpayers whose personal circumstances change during the tax year to return to the WC to determine if they should file a new Form W-4 to change their withholding.

[ITEM 3] YOUR COMPANY FACING A TIGHT JOB MARKET? CONSIDER THE WOTC

In IR-2018-113 [5/7/18], the IRS highlights the Work Opportunity Tax Credit (WOTC) as a mechanism for small businesses to save taxes through hiring workers from selected categories of the workforce. The IRS points out if it has been awhile since a company used the WOTC, recent legislation that expanded and modified the WOTC may be overlooked. For example, legislation effective 1/1/16 added a new category of WOTC-eligible workers: long-term unemployment recipients who had been

unemployed for a period of at least 27 weeks and received state or federal unemployment benefits during part or all of that time. In addition to this recently-added category, other worker categories are: (1) qualified IV-A temporary assistance for needy families recipients; (2) unemployed veterans, including disabled veterans; (3) ex-felons; (4) designated community residents living in Empowerment Zones or Rural Renewal Counties; (5) vocational rehabilitation referrals; (6) summer youth employees living in Empowerment Zones; (7) food stamp (SNAP) recipients; (8) Supplemental Security Income recipients; and, (9) long-term family assistance recipients. The WOTC first is figured on Form 5884, then becomes part of the general business credit claimed on Form 3800. The WOTC generally is based on wages paid to eligible workers during the first two years of employment. The employer first must request certification by filing Form 8850 with the state workforce agency within 28 days after the eligible worker begins work. Other requirements and details are on Form 8850. Generally, the WOTC is not available to tax-exempt organizations for most categories of new hires. However, a special rule permits tax-exempt organizations to claim the WOTC for hiring qualified veterans.

[ITEM 4] IRS REPORTS CERTAIN MILITARY PERSONNEL MAY QUALIFY FOR RETROACTIVE INCOME EXCLUSION

Under the TCJA '17, members of the U.S. Army, Navy, Marines, Air Force, and Coast Guard who performed services in the Sinai Peninsula now can claim combat zone tax benefits. In IR-2018-95 [4/13/18], the IRS states that eligible service members may be able to exclude part or all of their combat pay from their income for federal income tax purposes retroactive to June 2015. They may file an amended tax return, Form 1040X, if they already filed a tax return for tax years 2015, 2016 and 2017. Eligible service members should review Publication 3, Armed Forces' Tax Guide, available on IRS.gov. Combat pay received on or after January 1, 2018, will be correctly reported on any W-2 forms issued to any service member who serves in the Sinai Peninsula. Service members who served in the Sinai Peninsula in 2015, 2016, or 2017 can provide documentation of their service to their finance officer and ask for a Form W-2c, "Corrected Wage and Tax Statement." However, an eligible service member who is unable to secure a corrected Form W-2c still may claim the combat pay exclusion by attaching to his/her Form 1040X copies of official documents showing he/she served or worked in the Sinai Peninsula. These documents should indicate the area, theater or military operation and the approximate entry date. Acceptable documents include military orders, letters of authorization (civilians), hospital discharge papers, discharge from active duty, official letterhead memorandum from a military department or civilian employer, or a request and authorization for temporary duty travel of Department of Defense personnel (civilians and military)

[ITEM 5] IRS PROVIDES VEHICLE LIMITATIONS FOR 2018

In Revenue Procedure 2018-25 [4/17/18], the IRS specifies the depreciation deduction limitations for owners of passenger vehicles and light-duty trucks and vans placed into service in 2018. There no longer are different limitation amounts for trucks and vans. The TCJA '17 made significant increases to the limitations. These limitations are not indexed for inflation until 2019. For 2018, if the taxpayer does not claim bonus depreciation in 2018, the limitations for passenger vehicles placed into service in 2018 are as follows: 2018 – $10,000; 2019 – $16,000; 2020 – $9,600; and, each succeeding year $5,760. If bonus depreciation is claimed, the amount of the 2018 limitation depends on when the vehicle was purchased. The "Protecting Americans from Tax Hikes Act of 2015" extended bonus depreciation through 2019 but only extended the $8,000 increase in the first-year vehicle limit for 2015-2017. For 2018, the increase was to be only $6,400. A transitional rule following the TCJA '17 provides that if a vehicle was purchased after September 28, 2017, and placed into service in 2018, the bonus amount is $8,000. Otherwise, it is $6,400. Therefore, for taxpayers who claim bonus depreciation in 2018, the maximum 2018 depreciation for passenger automobiles placed into service in 2018 is $18,000 ($10,000 + $8,000) if it was purchased after September 28, 2017 and placed into service in 2018. Otherwise, it is $16,400 ($10,000+ $6,400).

[ITEM 6] IRS WRAPS UP 2018 LIST OF "DIRTY DOZEN" TAX SCAMS

In IR-2018-66 [4/5/18], the IRS issued its last of 12 separate internal releases on its 2018 "Dirty Dozen" tax scams. Here is the 2018 "Dirty Dozen" list: (1) *phishing schemes* – the IRS never initiates taxpayer contact via email about a bill or tax refund; (2) *phone scams* – the IRS notes the surge in con artists who threaten taxpayers with police arrest, deportation, and license revocation; (3) *identity theft* – tactics aimed at stealing taxpayer identities are done year long, not just during tax filing season; (4) *return preparer fraud*; (5) *fake charities* – be wary of charities with names similar to familiar or nationally-known organizations; (6) *inflated refund claims by return preparers*; (7) *excessive claims for business credits* – care should be employed in claiming the fuel tax credit, a credit not available to most taxpayers, and misusing the research credit through failures to participate in or substantiate qualified research activities or to satisfy the requirements related to qualified research expenses; (8) *falsely padding*

deductions on returns – charitable contributions and business expenses are items the IRS highlights, and improperly claiming credits, e.g., the earned income tax credit or child tax credit; (9) *falsifying income to claim credits* – the IRS mentions the earned income tax credit again with this scam; (10) *frivolous tax arguments* – it notes the $5,000 penalty for filing a frivolous tax return; (11) *abusive tax shelters* – when there is doubt, taxpayers should seek an independent opinion regarding complex products they are offered; and, (12) *offshore tax avoidance* – the IRS points up the importance of coming in voluntarily and catching up on tax-filing responsibilities.

[ITEM 7] IRS OFFSHORE VOLUNTARY DISCLOSURE PROGRAM TO CLOSE SOON

In IR-2018-52 [3/13/18], the IRS announces that it is winding down the "Offshore Voluntary Disclosure Program," and will close it on September 28, 2018. Since the program's initial launch in 2009, more than 56,000 taxpayers have used one of its programs to comply voluntarily, paying a total of $11.1 billion in back taxes, interest, and penalties. The program's end reflects advances in third-party reporting and an increased awareness of U.S. taxpayers of their offshore tax and reporting obligations. At the programs peak in 2011, about 18,000 people came forward, and since has steadily declined to only 600 disclosures in 2017. The IRS states that it will continue to use tools besides voluntary disclosure to combat offshore tax avoidance, including taxpayer education, whistleblower leads, civil examination, and criminal prosecution. A separate program, the Streamlined Filing Compliance Procedures, for taxpayers who might not have been aware of their filing obligations, has helped about 65,000 additional taxpayers come into compliance and it will remain in place and available to eligible taxpayers. Further, the IRS will continue to offer the following options for addressing previous taxpayer failures to comply with U.S. tax and information return obligations with respect to foreign financial assets: IRS-Criminal Investigation Voluntary Disclosure Program, delinquent FBAR submission procedures, and delinquent international information return submission procedures.

[ITEM 8] VIRTUAL CURRENCY TRANSACTIONS SUBJECT TO SAME GENERAL TAX PRINCIPLES AS OTHER PROPERTY

In IR-2018-71 [3/23/18], the IRS reminds taxpayers that income from virtual currency transactions is reportable on their income tax returns. Taxpayers not properly reporting the income tax consequences of virtual currency transactions can be audited, liable for penalties and interest, and even subject to criminal prosecution including tax evasion and filing a false tax return. Virtual currency generally is a digital representation of value that functions in the same manner as a country's traditional currency. Currently there are more than 1,500 known virtual currencies. Virtual currency is treated as property for U.S. federal tax purposes. So, the general tax principles that apply to property transactions also apply to transactions using virtual currency. Some of the general tax principles that apply include: (1) payments made using virtual currency are subject to information reporting in the same way as any other payment made in property; (2) virtual currency payments made to independent contractors and other service providers are taxable, and self-employment tax rules generally apply – payers normally must issue Form 1099-MISC; (3) wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes; and, (4) the character of gain (loss) from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the selling taxpayer's hands. Note: In Notice 2014-21, the IRS provides guidance for taxpayers and return preparers regarding transactions in virtual currency

[ITEM 9] IRS UPDATES 2018 CERTAIN ITEMS FOR TAX CUTS AND JOBS ACT

In the 2017 Winter issue of *The Elite Quarterly*, we reported various 2018 inflation-adjusted amounts affecting individuals under Revenue Procedure 2017-45. In Revenue Procedure 2018-18 [3/5/18], the IRS updates several of the amounts which were affected by the TCJA '17. For example, the new tax rates, standard deductions, and AMT exemptions are reported in the 2018 revenue procedure. These amounts were reported in our Spring 2018 issue. Also beginning in 2018, the new law authorizes a new index to compute the inflation adjustments (Chained Consumer Price Index for All Urban Consumers, or "C-CPI-U"). Below are a few of the more common provisions affecting individuals which have been adjusted for the new index. The income limit for the maximum earned income tax credit for 2018 is $6,780 for a qualifying individual with no children, $10,180 for a qualifying individual with one child, and $14,290 for a qualifying individual with either two or three or more children. The maximum 2018 earned income tax credit amounts are as follows: no child – $519; one child – $3,461; two children – $5,716; and, three or more children – $6,431. The taxpayer is not eligible for the earned income tax credit if certain investment income exceeds $3,500 in 2018. The amount that can be excluded from an employee's gross income for the adoption of a child (whether or not the child has special needs) is $13,810. The exclusion begins to phase out at a modified AGI of $207,140 and is completely phased out at $247,140. The foreign earned income exclusion is $103,900. For decedents dying in 2018, the basic exclusion amount for

determining the unified credit against the estate tax is $11.18 million. **Note:** The previous revenue procedure indicated that the amount used to determine the phaseout of the AMT exemption for estates and trusts was $500,000. Revenue Procedure 2018-22 [4/13/18] reports that the correct amount is $81,900.

As noted in the Spring issue of *The Elite Quarterly*, the maximum tax rate for C Corporations in 2018 is 21%. This compares to the maximum rates of 35% in 2017. The corporate AMT rate drops from 20% to zero. Fiscal-year corporations will use a blended rate to compute their tax in 2018. In Notice 2018-38 [4/16/18], the IRS illustrates how to calculate the correct tax for C Corporations whose fiscal year ends in 2018. First, the corporation calculates its tax for the entire taxable year using the tax rates in effect prior to the TCJA '17 . Second, it calculates its tax using the new 21 percent rate. Third, it proportions each tax amount based on the number of days in the taxable year when the different rates were in effect. Fourth, the sum of these two amounts is the corporation's federal income tax for the fiscal year. The blended rate applies to all fiscal year corporations whose fiscal year includes January 1, 2018. Fiscal year corporations that have already filed their federal income tax returns that do not reflect the blended rate may want to consider filing an amended return. The following example is taken from the notice.

Example. Corporation X, a Subchapter C corporation, uses a June 30 taxable year. For its taxable year beginning July 1, 2017, and ending June 30, 2018, X's taxable income is $1,000,000, and its AMTI in excess of its AMT exemption amount is $2,000,000. The steps to calculate the regular tax are as follows:

1.	*Tax on $1,000,000 based on pre-TCJA '17 rates ($1,000,000 x 34%)*	*$340,000*
2.	*Tax on $1,000,000 based on pre-TCJA '17 rates ($1,000,000 x 21%)*	*$210,000*
3a.	*Tax from 7/1/17 to 12/31/17 ($340,000 x 184 days/365 days)*	*$171,397*
3b.	*Tax from 1/1/18 to 6/30/18 ($210,000 x 181 days/365 days)*	*$104,137*
4.	*Total tax for the year – Sum of 3a and 3b*	*$275,534*

Note: *There is no corporate AMT since the prorated tentative minimum tax of $201,644 (20% x $2,000,000 AMTI x 184 days/365 days (no AMT during 2018)) is less than $275,534.*

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

1. Regarding a recent IRS ruling on home equity interest, **which one** of the following statements **is false**?
   a. If a home equity loan secured by the taxpayer's principal residence is used to make substantial improvements on a second home, the loan is considered acquisition debt.
   b. For 2018, the maximum amount of acquisition debt which qualifies for the residence interest deduction is $750,000.
   c. The TCJA '17 did not change the definition of acquisition debt.

2. **Which one** of the following responses **is false** about a recent IRS release dealing with withholding by individual taxpayers?
   a. The IRS recommends that with recent average refunds of $2,800 and 2017 TCJA '17 changes, individuals should consider reducing 2018 withholding.
   b. Individuals using the IRS's "Withholding Calculator" should have their 2017 tax return and most recent pay stubs available.
   c. The release was issued because of substantial 2018 increases in inflation-adjusted amounts.

3. **Which one** of the following responses about the Work Opportunity Tax Credit (WOTC) **is true**?
   a. Supplemental Security Income recipient wages may qualify for the WOTC for small businesses.
   b. An employer seeking to qualify for the WOTC requests worker certification by filing Form 5584 with the state workforce agency.
   c. The WOTC is not part of the general business credit.

4. For vehicles placed into service in 2018, **which one** of the following statements **is true** for the 2018 depreciation limitations?
   a. As in prior years, the limitations for light-duty trucks are more than the limitations for passenger vehicles.
   b. The maximum 2021 depreciation for passenger vehicles is $9,600.
   c. The maximum 2019 depreciation is less than the 2018 depreciation if bonus depreciation is claimed in 2018.

5. Regarding the IRS's 2018 list of "Dirty Dozen" tax scams, **which one** of the following responses **is false**?
   a. The IRS reports a surge in con artists who threaten taxpayers.
   b. The IRS is not concerned about taxpayers' claiming charitable contributions and business expenses.
   c. The IRS urges taxpayer care in claiming the fuel tax credit and the research credit.

Solutions

1. **"A" is the correct response**. In order to treat home equity debt used to make substantial improvements on a qualified residence, the residence which is being improved must be the security on the loan.
"B" is an incorrect response. The TCJA '17 reduced the amount of acquisition debt which qualifies for the residence interest deduction from $1,000,000 to $750,000, effective in 2018.
"C" is an incorrect response. The TCJA '17 made no changes to the definition of acquisition debt. *IR-2018-32.*

2. **"C" is the correct response**. No mention was made in the release about inflation-adjusted amounts.
"A" is an incorrect response. The release focused on the effects on 2018 withholding due to the 2017 TCJA '17, and mentioned recent $2,800 refunds.
"B" is an incorrect response. The IRS points out in the release that taxpayers should have their 2017 tax return and most recent pay stubs available when they use its "Withholding Calculator." *IR-2018-80*.

3. **"A" is the correct response**. SSI recipients are one of ten categories of workers whose wages may qualify for the WOTC for small businesses.
"B" is an incorrect response. The employer files Form 8850 with the state workforce agency.
"C" is an incorrect response. Once calculated, the WOTC is part of the general business credit claimed on Form 3800. *IR-2018-113*.

4. **"C" is the correct response**. The 2019 depreciation limitation on a vehicle placed into service in 2018 is $16,000 which is less than the 2018 limitation when bonus depreciation is taken ($18,000 or $16,400 depending on if the vehicle was purchased on or before September 28, 2017).
"A" is an incorrect response. There no longer are different limitation amounts for trucks and vans placed into service after 2017.
"B" is an incorrect response. The maximum 2021 depreciation for passenger vehicles placed into service during 2018 is $5,760 ($9,600 is the limitation for 2020). *Revenue Procedure 2018-25.*

5. **"B" is the correct response**. Charitable contributions and business expenses are items the IRS highlights as deductions that are padded on tax returns.
"A" is an incorrect response. The IRS notes the surge in con artists who threaten taxpayers with police arrest, deportation, and license revocation.
"C" is an incorrect response. The IRS urges care in claiming the fuel tax credit because it is not widely available to taxpayers, and the research credit when taxpayers fail to participate in or substantiate qualified research activities or to meet the requirements related to qualified research expenses. *IR-2018-66*.

COURT DECISIONS

[ITEM 10] TAX COURT DECIDES CHARACTER OF PROPERTY THAT IS SOLD, AND WHETHER LOAN INTEREST IS CAPITALIZED

On 1/21/2000, the taxpayers purchased an historic waterfront mansion for $1.35 million in Newport, RI. They lived in another home in Newport from May, 2000 until September, 2005, when they moved to Tampa, FL, where they lived until they moved to New York in October, 2009. The mansion was uninhabitable when the taxpayers purchased it. They intended to restore it. On 10/30/2002, they divided it into two units – the Wrentham Mansion (WM) and the Carriage House (CH). On 11/1/2002, they sold CH. They financed the purchase of the mansion and the restoration of WH through a series of loans. Restoration began at the end of 2002 and continued until completion in May, 2008. The wife regularly oversaw the WH restoration when they lived in Newport, then when they moved they returned frequently to oversee construction, or managed progress through telephone calls. State and federal tax credits were available to help defray costs, but the taxpayers obtained neither, even though they did not intend to reside in WM. From 2006 until completion, the taxpayers were in touch with a rental agent about ultimately renting WM, but they never rented it. During the 5/7/2004 - 7/31/2009 period, WM was listed for sale. With no rental activity nor sales progress, the lender increased its monthly mortgage payment from $25,000 to $39,000 in 2008. Struggling with the financial burden of WM, the taxpayers pursued other avenues to sell the property, until on 7/31/2009, they sold WM in a short sale. There were two issues that the Tax Court addressed in Keefe [3/15/18]. The first issue concerned whether WM was business property or a capital asset when the taxpayers sold it. The taxpayers originally reported the sale on their federal income tax return as sale of a capital asset and claimed a capital loss. Later they amended their return and treated it as a sale of business property, generating a net operating loss. The second issue was whether the $3.3 million of loan interest secured by WM mortgages had to be capitalized and added to the basis of WM. The court stated that a capital asset is property that a taxpayer

holds (whether or not connected with a business) but is not property used in a taxpayer's trade or business for which depreciation is permitted, or real property used in a taxpayer's trade or business. Property held to produce income, but not used in a trade or business, is a capital asset and subject to capital loss limitations. It noted that the 2nd Circuit (to which its decision would be appealable) requires that taxpayers be engaged in continuous, regular, and substantial activity (CRSA) in relation to the management of the property to conclude the property was used in a trade or business and not held as a capital asset. The taxpayers asserted they held WM as an asset used in a rental real estate business. The Tax Court stated that the 2nd Circuit considers the following factors in examining CRSA: taxpayer's efforts to rent the property, maintenance supplied by taxpayer or his agent, taxpayer's employment of labor to manage the property or provide services to tenants, the purchase of materials, the collection of rent, and the payment of expenses. While it agreed the taxpayers spent a lot of time, effort, and expense to renovate the property, the court observed that WM never was held out for rent or rented after the restoration was complete. It ruled WM was a capital asset. As to interest expense with respect to WM, the IRS argued capitalization of interest expense on loans used to acquire and restore WM. The court stated that interest expenses are capitalized to the extent they are paid or incurred during the period in which the property is being constructed or produced and are allocable to real property. For purposes of Section 263A capitalization, improvements to property constitute the production of property (e.g., the extensive restoration work performed on WM). It stated that the production period begins on the date on which the physical production activity first is performed and ordinarily ends on the date that the property is ready to be placed in service or held for sale. Further, the production period does not end for a unit of property before the completion of physical production activities by the taxpayer even though the property is held for sale or lease. For WM, the court ruled that the production period began on the date the physical restoration work began and ended on the date of completion of the physical construction work on WM, and that interest expenses paid or incurred during the production period must be capitalized.

[ITEM 11] TAX COURT CONSIDERS WHETHER LAND SALE GENERATES ORDINARY OR CAPITAL GAIN INCOME

Normally, if a developer buys land, develops it, and sells it in parcels, the character of the income is ordinary. Section 1221(a)(1) excludes from the definition of capital asset inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. So, if a developer sells the lots it develops, any gain or loss from the sale of the lots is ordinary. However, what happens if circumstances change and the developer never develops the land but rather sells it in bulk? The Tax Court in Sugar Land Ranch Development, LLC [2/22/18] addresses this issue. An LLC was formed principally to acquire contiguous tracts of land in Texas and to develop that land into single-family residential building lots and commercial tracts. During 1998 it acquired 943 acres. The property formerly had been an oil field and was adjacent to property being developed by parties related to the LLC. The original plan was to clean up the property and subdivide it into residential units. Between 1998 and 2008 the LLC capped oil wells, removed oil gathering lines, did some environmental cleanup, built a levee, and entered into a development agreement with the local city. During this time about 118 acres of the property were sold. The remaining 825 acres, which were contiguous, were divided by three easements. Late in 2008, the managers of the LLC believed that they would not be able to develop, subdivide, and sell residential and commercial lots from the property because of the effects of the subprime mortgage crisis on the local housing market and the scarcity or unavailability of financing for housing projects in the wake of the financial crisis. Instead, the mangers decided that the LLC would hold the property as an investment until the market recovered enough to sell it off. These decisions were memorialized in a "Unanimous Consent" document dated December 16, 2008. In 2011, a major homebuilder approached the managers about buying the three parcels. It purchased one parcel in 2011 and the remaining two parcels in 2012. Only the latter two sales are at issue in this case. Both of the 2012 sales contracts consisted of a lump-sum payment and a contingent payment. In one contract, the contingent payment was 2% of the final sale price of each future home eventually developed and $3,500 for each recorded plat. The second contract did not contain a 2% clause but it did include a $2,000 payment for each recorded plat. None of these contingent payments were received in 2012. The Tax Court noted that while the original intent of the LLC was to sell lots from the land parcels in the ordinary course of business, the LLC never marketed the parcels by advertising or other promotional materials. Nor did the managers devote any time or effort in selling the property. Most importantly, the Tax Court indicated that the sale of the two parcels was essentially a bulk sale of a single, large, and contiguous tract of land to a single seller--clearly not a frequent occurrence in the LLC's ordinary business. It rejected the IRS's argument that the extent of development of the parcels shows that these properties were held primarily for sale in the ordinary course of business. The court also disagreed with the IRS claim that the frequency of sales along with the nature of the LLC's business demonstrated that the sales were ordinary income. To the contrary, the Tax Court noted that after 2008 there were a total of only nine sales of property over eight years. The Tax Court also indicated that while the contracts provided for various additional payments when a plat was recorded or when a home sale closed, the nature of these additional payments does not illuminate the character of the net gain at issue in this case. On the basis of all the evidence,

the Tax Court concluded that the LLC was not engaged in a development business after 2008 and that the two properties sold in 2012 were held as investments. Accordingly, it ruled that the character of the gains and losses from the sales of these properties was income from the sale of capital assets.

[ITEM 12] ELEVENTH CIRCUIT AFFIRMS TAX COURT'S CHARACTERIZATION OF NONREFUNDABLE DEPOSIT

In CRI-Leslie [2/15/18], the taxpayer purchased a prime waterfront hotel and restaurant in Tampa in 2005. In 2006, it reached an agreement to sell the property to another company for $39 million. Over the course of the next two years – during which the taxpayer continued to operate the hotel and restaurant – the parties amended the contract several times, eventually settling on a total purchase price of $39.2 million, $9.7 million of which was paid immediately to the seller as a nonrefundable deposit and would thereafter be credited toward the purchase price at closing. Unfortunately, in 2008, the buyer defaulted on the agreement and forfeited the $9.7 million deposit. On its 2008 tax return, the taxpayer reported the forfeited deposit as long-term capital gain. The IRS sent an adjustment for the taxpayer's 2008 tax return claiming that the taxpayer improperly reported the amount of the forfeited deposit as net long-term capital gain rather than ordinary income. The Tax Court agreed with the IRS. The property in question is considered trade or business property under Section 1231 and had the sale gone through, the gain would have been taxed as long-term capital gain. The Eleventh Circuit noted that the crux of the matter was whether the deposit was considered a capital asset under Section 1234A. This provision deals with the tax treatment of gains and losses from certain terminations. It provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset. The court indicated that this provision ensures capital-gains treatment of income resulting from canceled property sales by relaxing the "sale or exchange" element of the Code's general definition of long-term capital gain. So, the issue here is whether the hotel and restaurant property are considered a capital asset under Section 1221. The court argued that this provision defines the term "capital asset" in a way that expressly excludes the property from capital asset. Namely, Section 1221(a)(2) states that the term capital asset does not include property, used in a trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in a trade or business. The taxpayer countered that a plain-text reading of the Code impermissibly yields a result that is "illogical, absurd, and directly contrary to the objective of Section 1234A." Specifically, the taxpayer argued that different tax treatment for capital asset deposits and trade or business property deposits is internally inconsistent. The tax treatment of a deposit for a pending sale of the former property is capital gain whether or not the sale goes through whereas the tax treatment of a deposit on the latter property is dependent on whether the sale goes through. The Eleventh Circuit indicated that it found no basis for disregarding the clear language of the statute. While the court agreed that the disparate treatments were odd, it did not believe that the result was absurd. It also indicated that when the contest is between clear statutory text and evidence of sub- or extra-textual "intent," the former must prevail. The Eleventh Circuit concluded its ruling by stating "if Congress thinks that we've misapprehended its true intent – or, more accurately, that the language that it enacted in I.R.C. §§ 1221 and 1234A inaccurately reflects its true intent – then it can and should say so by amending the Code." **Note:** Clearly, Section 1234A applies only to capital assets. However, does that imply that the character of all other forfeited deposits should be ordinary income? Section 1234A does not mandate this treatment. An argument can be made that the character of the gain from the forfeited deposit should be based on the character of the property that is to be sold.

[13] TAX COURT DECIDES CONSEQUENCES OF SHORT SALE AND DISCHARGED NONRECOURSE DEBT

A couple bought a townhouse in northern California in 2005, financing 80% with nonrecourse debt. They made some home improvements over the first two years, the great recession started, and their home value sank. They lived five years in the home before they moved to southern California in 2010. At that time, they rented out the townhouse for a short period. With no rebound in the market, and their home's value far less than the nonrecourse debt balance on it, the couple negotiated a short sale with the lending bank and a third-party buyer in November 2011. They sold their home to the third party for an amount that fell short of the debt balance. The lender agreed to release its lien on their home to facilitate the sale and the couple agreed to give all of the sales proceeds to the lender. The bank used the proceeds to pay down the loan and cover approximately $26,000 of sale closing costs. In January 2012 the couple received Form 1099-C, "Cancellation of Debt" for $219,270 for the cancelled debt, and Form 1099-S, "Proceeds from Real Estate Transactions" for the $363,000 sales proceeds they received. The couple and the IRS agreed with the $219,270 cancelled debt amount: $555,960 loan balance +$26,310 closing costs - $363,000 sale price. The couple argued that the COD income was covered by the exclusion for discharged "qualified principal residence debt" in Section 108 because they had used the property as their principal residence at least two of the five years before they sold it. They also argued that they sustained a $216,495 loss on the sale for the excess of the property's $579,495 adjusted basis over the

$363,000 sale price. The IRS argued that the short sale was one transaction, and that the amount realized on the sale included the nonrecourse debt balance at the short sale date. The issue in Simonsen [3/14/18] was the computation of gain or loss on the short sale. The taxpayer's position was that there were two separate transactions that resulted in a substantial deductible loss and excludable cancellation of debt (COD) income. The IRS's position was that there was but one transaction, the discharged debt was included in the amount realized on the sale, and there was neither a deductible loss nor COD income. The taxpayers and the IRS agreed that the taxpayers converted their townhouse to a rental property in September 2010. The court considered whether the short sale was just a sale or exchange that yielded gain or was two transactions – one generating loss and the other generating COD income that the taxpayers argued was excludable. The court held that the sale and the debt discharge were one transaction, generating gain/loss on sale, and no COD income. The court stated the key point was the complete dependence of the bank's willingness to cancel the debt on the taxpayers' willingness to turn over the proceeds from the sale of their home. It likened the result for the short sale to that for foreclosures, deed-in-lieu transactions, repossessions, and abandonments. The court computed the gain / loss on the sale. For the nonrecourse debt, the court noted that the law requires that the amount realized on the sale of property encumbered by nonrecourse debt includes the full amount of the debt. Since the taxpayers were relieved of the responsibility to repay the nonrecourse debt when the sale closed, the amount realized was the $555,960 of discharged nonrecourse debt. The court applied the gift rules to compute gain or loss at sale. As the taxpayers' residence had been converted to rental property, the court found that the basis to be used at sale was the lower of their original purchase price of $695,000 (to calculate gain) or the property's fair market value of $495,000 at time of conversion (to calculate loss), adjusted for depreciation. Since the $555,960 amount of realized fell between the "gain basis" and the "loss basis," there was neither gain nor loss on the sale.

[ITEM 14] TAX COURT GRANTS HUSBAND INNOCENT SPOUSE RELIEF

In Heedram [3/7/18], during the four years of the couple's marriage, the wife was responsible for financial and tax matters. She had unpaid federal taxes before their marriage, entered into an IRS payment plan to pay them, and stopped payments after a couple of months. They filed their last joint return in 2014. Their divorce was final in2015. In their final divorce decree, each spouse agreed to pay taxes attributable to each's income for the tax years they filed returns. The husband filed Form 8857 for innocent spouse relief for 2014, and the IRS denied relief under Section 6015(f). The husband was employed and, after sending an amount to his mother in Jamaica to support his two children and her, his earnings left him with very little at the end of the month. The issue in the case was whether Section 6015(f) applied to grant the husband "equitable relief" from joint and several liability. Section 6015(f) may apply if the taxpayer is not eligible for relief under Section 6015(b) or Section 6015(c). Sections 6015(b) and (c) deal with understatements of tax attributable to erroneous items of one individual filing the joint return. In this case, there was a failure to pay the tax shown on the return rather than the reporting of erroneous items. Therefore, only Section 6015(f) relief was available. Under Section 6015(f), the IRS may grant equitable relief from joint and several liability on a joint return if it is inequitable under the facts and circumstances to hold the individual liable for any unpaid tax. Revenue Procedure 2013-34 outlines seven threshold conditions a spouse must meet initially to qualify for Section 6015(f) relief from joint and several liability. The IRS conceded the husband met the seven threshold conditions for relief from tax liability associated with his wife's income. The court still had to determine if he met any of the exceptions to relieve him of liability for the tax on his income. The Tax Court found no exceptions applied, and so he did not qualify for relief on tax attributable to his income. The court then examined two items beyond the threshold conditions to determine if he qualified for relief from tax on his wife's income. First, it examined three specific conditions (all of which must be met) that would qualify him for a streamlined determination for relief under Section 6015(f). It concluded he did not meet all three conditions. Second, the court examined a separate set of seven nonexclusive factors in Revenue Procedure 2013-34 to determine if he was relieved of the tax on her income. Regarding each, the court concluded the following: (1) marital status (favored relief) – even though the two were married when he filed Form 8857, and they continued to live together after their divorce was final, the court noted they lived together only because of financial issues, and they no longer were living together at the time of trial; (2) economic hardship (neutral) – the court noted that a taxpayer suffers economic hardship if satisfaction of the tax liability would cause him to be unable to pay reasonable living expenses; even though the husband did not have much money left at the end of the month after paying living expenses, it could not conclude he would suffer economic hardship; (3) for an underpayment as in this case, whether the husband knew or had reason to know his wife would not or could not pay the joint return tax liability (favored relief) – although he knew the tax liability would not be paid when the joint return was filed, he believed his wife would set up another payment plan; also, she earned most of the wages in 2014, and handled the couple's finances; (4) legal obligation (favored relief) – the court found that he had a reasonable belief that she would set up a new payment plan to pay the tax on her share of the couple's income; (5) significant benefit (favored relief) – the court agreed with the IRS's concession that neither spouse received a significant benefit from the unpaid tax liability; (6) compliance with tax laws

(neutral) – the couple had not included on the return income reported on a Form 1099-MISC for the husband for 2014; the facts showed he had stopped working for the 1099 provider in 2013, and the court found the IRS offered no evidence to connect the husband with the 1099 income in 2014; and, (7) mental or physical health (neutral) – the court found no evidence of health problems. The court concluded all of the factors either favored relief or were neutral. The court ruled it would be inequitable to hold the husband liable for the taxes on his wife's share of the income on the return because of the relative financial positions and sophistication of his wife in their marriage.

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

6. Regarding a recent case where property was improved over a number of years and ultimately was sold, **which one** of the following **was not** a factor the Tax Court examined in deciding if the taxpayers used the property in a trade or business, or held it as capital asset?
   a. Taxpayers' efforts to rent the property.
   b. Taxpayers' employment of labor to manage the property.
   c. Whether taxpayers claimed tax credits that would have defrayed their restoration costs.

7. In a recent Tax Court case dealing with the character of gain from the sale of land, **which one** of the following statements **is true**?
   a. Numerous parcels of land were sold to many buyers during the year in question.
   b. The Tax Court ruled that the gain was capital gain.
   c. Significant marketing efforts to sell the land were made during the year in question.

8. In a recent court case involving the forfeiture of a nonrefundable deposit, **which one** of the following statements **is false**?
   a. The Eleventh Circuit ruled that the gain was ordinary income.
   b. The taxpayer argued that the character of any gain from the receipt of a nonrefundable deposit should be the same whether the sale went through or not.
   c. There are no Code provisions which specifically define the character of gains realized from the receipt of a nonrefundable deposit which is forfeited.

9. **Which one** of the following responses **is true** about a recent case involving a short sale of property which had a nonrecourse debt balance?
   a. The Tax Court agreed with the IRS that the short sale was one transaction.
   b. Because the nonrecourse debt balance at sale was less than the property's original purchase price, there was a loss at sale.
   c. The court ruled that the taxpayer was required to report as cancellation of debt income the amount reported to him on Form 1099-C, "Cancellation of Debt."

Solutions

6. **"C" is the correct response**. Although state and federal tax credits were available to help defray costs in restoring the property and the taxpayers obtained neither, this was not a factor the court used in deciding how the taxpayers held the property.
   "A" is an incorrect response. This is the first factor in the list of CRSA factors the court considered.
   "B" is an incorrect response. This is the third factor in the list of CRSA factors the court considered.
   Keefe.

7. **"B" is the correct response**. The Tax Court concluded that the LLC was not engaged in a development business after 2008 and that the two properties sold in 2012 were held as investments. Therefore, it ruled the gain was capital gain.
   "A" is an incorrect response. After 2008 when the managers of the LLC decided to discontinue developing the land, there were a total of only nine sales of property over eight years.
   "C" is an incorrect response. The LLC never marketed the parcels by advertising or other promotional materials. *Sugar Land Ranch Development, LLC.*

8. **"C" is the correct response**. There is a code section (Section 1234A) which defines the character of certain gains from the receipt of nonrefundable deposits from terminated sales contracts but it only applies to terminated sales of capital assets.
   "A" is an incorrect response. Since the terminated sale involved trade or business property, the court held Section 1234A did not apply and the gain was ordinary income.
   "B" is an incorrect response. The taxpayer argued that there is inconsistent tax treatment between deposits received from pending sales of capital assets and trade or business assets. Specifically, the tax treatment of a deposit on the latter property is dependent on whether the sale goes through, where it is capital

gain for a capital asset whether or not the sale goes through. *CRI-Leslie*.

9. **"A" is the correct response**. The Tax Court ruled consistent with the IRS's position, that the short sale was one transaction.
"B is an incorrect response. The court applied the gift rules and used the fair market value of the property when it was converted to rental property as its basis to compute loss. As the amount realized (debt balance) exceeded the fair market value of the property at the time of the short sale, there was realized gain, not loss. However, the gain is not recognized as the basis to calculate gain is the basis before converting the property from personal use to rental property.
"C" is an incorrect response. While Form 1099-C provided the taxpayer showed $219,270 cancellation of debt income, the court found no cancellation of debt income because it treated the sale and cancellation of debt as one transaction, for which the cancelled nonrecourse debt balance was included in the amount realized. *Simonsen*.

TREASURY

[ITEM 15] THE TIGTA REPORTS THAT MOST EMPLOYMENT IDENTITY THEFT VICTIMS HAVE NOT BEEN NOTIFIED

In Report Number 2018-40-016 [1/12/18], the Treasury Inspector General for Tax Administration (TIGTA) examines whether victims of employment-related identity theft are notified in a timely manner. Employment-related identity theft occurs when an identity thief uses another person's identity to gain employment. Employment identity theft can cause a significant burden to innocent taxpayers, including the incorrect computation of taxes based on income that does not belong to them. Cases of employment identity theft identified by the IRS usually involve an Individual Taxpayer Identification Number (ITIN) filer who used the Social Security Number (SSN) of another individual to gain employment. The TIGTA reviewed information obtained from the Identity Theft Protection Strategy and Oversight office in Washington, D.C., during the period March through November 2017. In response to a prior TIGTA Treasury audit, the IRS developed processes to notify taxpayers identified as victims of employment identity theft. Specifically, the IRS began notifying SSN owners who have an employment identity theft marker placed on their account on or after January 1, 2017. Once identified, the IRS sends the victims a CP01E (701E in Spanish) notice. This notice informs the recipient that the IRS believes another person used the taxpayer's SSN to obtain employment and provides actions the taxpayer can take to mitigate the effects of identity theft. The TIGTA found that the IRS did not send the CP01E notice to 458,658 taxpayers whose SSNs were used to report income by an ITIN filer on a 2017 e-filed tax return. A programming error limited notifications to only those victims whose information was identified on an ITIN/SSN mismatch return who were not previously identified as a victim. Each of these taxpayers' SSNs was used by an ITIN filer prior to 2017 and identified by the IRS as a victim of employment identity theft. At the time of the report, the 458,658 victims had not been notified. The TIGTA recommended that the IRS notify these individuals and the IRS agreed. The review also found that for the 112,445 notices that were sent during the period of February 27, 2017, to May 22, 2017, 15,168 (13.5 percent) notices were erroneously sent to taxpayers. The TIGTA recommended that the IRS reverse the employment identity theft marker placed on the 15,168 taxpayers' accounts and notify them that the prior notice was sent erroneously. In addition, it recommended that the IRS (1) revise the ITIN/SSN mismatch programming to ensure that it does not place the employment identity theft marker on the accounts of SSN owners who are spouses of ITIN holders, and (2) identify instances, prior to 2017, in which the ITIN/SSN mismatch process erroneously placed the employment identity theft marker on the tax accounts of SSN owners who are spouses of ITIN holders.

SPECIAL TOPICS

CANCELLATION OF DEBT

This special topic reviews fundamental issues connected with cancellation of debt income. We also cover a recent case in which the Tax Court found that a taxpayer's student loan balance that was cancelled had to be included in gross income.

[ITEM 16] BASIC REVIEW OF CANCELLATION OF DEBT

Section 61 provides that gross income specifically includes income from the discharge of debt. There are some exceptions to this rule which apply before the five specific exclusions listed below. If debt is cancelled as a gift or inheritance, the recipient generally does not have gross income. For certain

student loans that an individual has, there is no gross income for the student loan discharge if the discharge was pursuant to a loan provision under which all or part of the individual's debt would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers. However, if the loan cancellation is for services that the student performed for the educational organization or another organization that provided the funds for the loan, the loan cancellation amount must be included in gross income. The student loan generally must have been made by (1) the United States, any instrumentality or agency of the United States, or a state, territory, or United States possession, (2) a "public benefit corporation," or (3) an educational institution.

Section 108 states that in five specific cases gross income from debt discharge may be excluded from gross income. The debt discharge must not be for some reason other than debt forgiveness alone. For example, if the taxpayer / debtor agrees to provide services for the creditor to fully satisfy the debt, there is no cancelled debt. Instead, the debtor has income from services performed. The five cases where debt discharge may be a gross income exclusion are: (1) debt discharge that occurs in a Title 11 bankruptcy case; (2) debt discharge that occurs when the taxpayer is insolvent; (3) debt discharge that is qualified farm debt; (4) for taxpayers other than a C Corporation, debt discharge that is qualified real property business debt; and, (5) debt discharge that is qualified principal residence debt. The TCJA '17 provides that qualified principal residence debt must have been discharged before January 1, 2018, or was subject to an arrangement entered into and evidenced in writing before January 1, 2018. There are a number of coordinating provisions for the various exclusions. None of instances (2) - (4) apply if the debt that is discharged occurs in a Title 11 bankruptcy case. Instances (3) and (4) do not apply to a debt discharge to the extent that the taxpayer is insolvent. The insolvency exclusion generally does not apply to a discharge where the debt discharged is qualified principal residence debt unless the taxpayer elects to apply the insolvency exclusion in lieu of the qualified principal residence debt exclusion. Regarding the insolvency exclusion, the exclusion amount is limited to the amount by which the taxpayer is insolvent. In some cases when the taxpayer is permitted to exclude debt discharge from gross income, the taxpayer may have to reduce certain tax attributes. The Title 11 exclusion is a case under Title 11 of the United States Code dealing with bankruptcy. Title 11 includes Chapter 7, 11, and 13 bankruptcies. The taxpayer must be under the court's jurisdiction, and the debt discharge must be granted by the court in a court-approved plan. The bankruptcy court must grant the discharge either in a specific order, or as part of a plan that is approved by the court.

Regarding the insolvency exclusion, the amount of the exclusion cannot exceed the amount by which the taxpayer/debtor is insolvent. Insolvency is the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets immediately before the discharge. So, the discharged debt may count as a liability in calculating the taxpayer's insolvency. Assets include the value of everything that the taxpayer owns – they include assets that are collateral for debt, as well as exempt assets beyond the reach of creditors under the law, e.g., the taxpayer's interest in a pension plan or the value of the taxpayer's retirement account.

Example 1: D owes $20,000 to C and has $25,000 of other liabilities. The fair market value of D's assets is $31,000. C discharges D's $20,000 debt for C's payment of $4,000. D has $16,000 ($20,000 - $4,000) of cancellation of debt income. D excludes $14,000 ($20,000 + $25,000 - $31,000) of the $16,000 from gross income.

A taxpayer's nonrecourse debt is treated as the taxpayer's debt. For purposes of the insolvency calculation, liabilities include the (1) entire amount of recourse debt, (2) the part of nonrecourse debt not in excess of the fair market value of the property that is used as security for the debt, and (3) the part of nonrecourse debt that exceeds the fair market value of the property subject to the nonrecourse debt, to the extent the nonrecourse debt in excess of the fair market value of the property subject to the debt is forgiven.

Example 2: D owes $1 million of nonrecourse debt to C. The debt secures an office building with a current fair market value of $800,000 that D owns. C discharges $175,000 of the debt, reducing the debt's principal amount to $825,000. D also owns other assets with a fair market value of $100,000 and has recourse debt of $50,000. Assets include $800,000 for the building and $100,000 of other assets. For purposes of the insolvency calculation, liabilities include $50,000 of recourse debt, $800,000 of nonrecourse debt (nonrecourse debt not exceeding the fair market value of the property that it secures), and $175,000 more of the nonrecourse debt (the part of the debt in excess of the $800,000 fair market value of the secured property that is forgiven). D's insolvency is calculated as $125,000 [($50,000 + $800,000 +$175,000 of liabilities) - $900,000 of assets]. So, $125,000 of the $175,000 discharged debt is excluded from D's gross income, and $50,000 is included in gross income.

The "qualified farm debt exclusion" applies only to the discharge of "qualified farm indebtedness" by a "qualified person." Debt that qualifies for this exclusion is debt incurred directly in connection with the operation of a farming trade or business, if at least 50% of total gross receipts in the three prior years were from the trade or business of farming. Generally, a person who qualifies is an unrelated individual, organization, partnership, association, corporation, or other person who is actively engaged in the business of lending money. This exclusion is applied after the Title 11 and insolvency exclusions.

There is a limit on the amount of the exclusion.

As stated earlier, the "qualified real property business debt" [QRPBD"] exclusion applies only to taxpayers who are not C Corporations. The exclusion applies when the Title 11 and insolvency exceptions do not apply. QRPBD is debt that was incurred in connection with real property used in a trade or business, is secured by that real property, and was incurred before 1993 or, if after 1992, meets specific requirements. The taxpayer makes an election of the property to which he will apply the QRPBD rules. The election must be made on a timely filed return or extension and is revocable only with IRS consent. The debt forgiveness eligible for this exclusion is limited.

Recall that the "qualified principal residence debt exclusion" applies only to debt discharge arrangements that were entered into and evidenced in writing before January 1, 2018. Under this rule, cancellation of debt income from such debt discharges is excluded from gross income. The debt generally must be for a mortgage taken out to buy, build, or substantially improve the taxpayer's main home ("qualified principal residence indebtedness"). If the debt cancellation is in a Title 11 bankruptcy case, the Title 11 exclusion rules apply. The maximum amount that the taxpayer can treat as qualified principal residence indebtedness is $2 million ($1 million on a married filing separately return).

For cancellation of debt income excluded from gross income under the Title 11, insolvency, and qualified farm debt exclusions, the exclusion amount must be applied to reduce certain tax attributes (but not below zero) of the debtor. These rules do not apply if the cancellation of debt income results from the qualified real property business debt and qualified principal residence debt exceptions. However, the basis of the depreciable real property (real property business debt exception) and principal residence (principal residence debt exception) must be reduced by the amount of cancellation of debt income excluded under the provision.

For the Title 11, insolvency, and qualified farm debt exceptions, the taxpayer's tax attributes are reduced in the following order: (1) NOLs and NOL carryovers to the discharge year; (2) general business credit carryovers; (3) minimum tax credit; (4) capital losses and capital loss carryovers to the discharge year; (5) basis of the debtor's depreciable and nondepreciable assets; (6) passive activity loss and credit carryovers; and, (7) foreign tax credit carryovers. The reductions are made after the tax is computed for the tax year of the discharge. If the debtor has tax attributes that may be carried back to tax years preceding the year of the debt discharge, they are taken into account for those preceding years before the attributes are reduced. The attribute ordering may be changed if the taxpayer elects to reduce the basis of depreciable property first. If the excluded income is more than the debtor's tax attributes, the excess is permanently excluded from the debtor's gross income, i.e., the excess is disregarded and has no income tax consequences.

[ITEM 17] TAX COURT DETERMINES IF PARENTS' SAVINGS ACCOUNT HELD BY SON IS INCLUDED IN APPLYING INSOLVENCY EXCEPTION

The issue in Hamilton [5/8/18] was whether a husband and wife were insolvent under the Section 108(a)(1)(B) insolvency exclusion provision. The taxpayer / father obtained student loans to finance the couple's son's education. In 2008 the father was diagnosed with degenerative disc disease and was permanently disabled. In June 2010 he sought to have the student loans discharged because of his disability. In 2011 the creditor discharged $158,511 of the debt. Also, in 2011 the father received a $308,105 nontaxable cash distribution relating to his interest in an LLC. During 2011 the father engaged in erratic spending behavior, his wife began managing the couple's finances, and they transferred $323,000 to their son's bank savings account. The son gave his mother his bank account username and password and gave her permission to transfer funds from his savings account. Throughout 2011 she regularly transferred money from their son's savings account to their joint account, the source she used to pay a majority of the household bills. The couple's CPA prepared their 2011 return, advised them they were insolvent, and that they were not required to include any debt discharge in their gross income. The taxpayers attached Form 982, "Reduction of Tax Attributes Due to Discharge of Indebtedness," to their 2011 return claiming their liabilities exceeded their assets by $165,871. The IRS issued them a notice for a $44,313 tax deficiency. The taxpayers and the IRS agreed that if their son's savings account were not taken into account, they would meet the insolvency provision for excluding the cancelled debt from their gross income. The Tax Court examined if the savings account should be considered in determining the couple's insolvency. The court stated that insolvency is the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets immediately before the discharge, and the income exclusion for debt cancellation cannot exceed the amount by which the taxpayer is insolvent. The taxpayers asserted they were insolvent and had no debt discharge income. The IRS asserted that their son held his savings account as a nominee for his parents, and the amount of his savings account should be considered in determining his parents' insolvency status. The court looked first to state law rather than federal law to determine if their son held his savings account as his parents' nominee. It stated that Utah courts use six factors to determine if a nominee relationship exists: (1) taxpayer exercises dominion and control over the property while the property is in the nominee's name; (2) nominee paid little or no consideration for the property; (3) taxpayer placed the property in the nominee's name in anticipation of a liability or lawsuit; (4) a close relationship exists between taxpayer and

nominee; (5) taxpayer continues to enjoy the benefits of the property while it is in nominee's name; and, (6) the conveyance to nominee is not recorded. The court noted that although the transferred funds were placed into their son's savings account, his mother could freely transfer funds to her husband's and her joint account to pay household bills, and so she exercised dominion and control over the account. It found no evidence that their son paid any consideration for the funds transferred to his savings account, or that the funds were transferred in anticipation of a lawsuit or a liability. It found sufficient evidence to establish a close relationship between the taxpayers and their son, and that they continued to enjoy the benefits of the funds they transferred to the savings account. It concluded the couple could not establish that their son was not their nominee for the savings account funds. So, the savings account value was part of their assets. It ruled that for 2011 their assets exceeded their liabilities by at least $60,002, and thus their $158,511 of cancelled debt must be included in the couple's gross income.

HOLDING REAL ESTATE RENTAL PROPERTY AS CO-OWNERS OR THROUGH AN LLC INTEREST

In the Court Decision section of our newsletter, we reported on three cases dealing with the character of income where in two cases the court decided the gain was capital gain, and in the other case the court decided it was ordinary income. Because of the tax differences between capital gain income, trade or business income, and ordinary income, proper tax planning can result in significant tax savings. Suppose two or three family members or friends wish to own rental property or vacation property together. Traditionally, the property could be owned as co-owners or through a partnership. With the advent of limited liability companies (LLCs), it is prudent from a liability standpoint for the property to be owned by the LLC. However, does this nontax advantage result in a tax advantage or disadvantage when compared to owning property as co-owners? This special topic explores this question and focuses on the tax consequences from a disposition of an owner's interest in real estate rental property.

[ITEM 18] SOME TAX DIFFERENCES IN DISPOSING OF PROPERTY HELD AS CO-OWNERS VERSUS THROUGH AN LLC INTEREST

When there is only one owner, the LLC can be disregarded and the rental income is reported on Schedule E of the owner's personal tax return. However, under the check-the-box regulations, if there are two or more owners and the property is owned through an LLC, the LLC cannot be disregarded. That is, each owner cannot report his/her share of gross rents and expenses on page 1 of Schedule E as a co-owner. Instead, the LLC must be treated as a corporation or partnership for tax purposes. Typically, the LLC is treated as a partnership so its rental losses in the early years can pass through to each owner. One might ask what difference it makes whether owners report their share of gross rents and expenses on page 1 of Schedule E or report their share of net rental income from a partnership on page 2 of Schedule E. In most cases, there are few tax differences in computing net rental income each year, particularly if the depreciation method chosen by an LLC is the same as each LLC member would choose if the property were owned as a co-ownership. There can be significant tax differences between owning an interest in real estate rental property as co-owners versus a partnership when one of the owners wants out but the other owners wish to continue holding the rental property. Examples 1-3 illustrate these tax differences. Example 4 illustrates the potential tax consequences if the ownership interest is sold to a related party.

Example 1: Individuals A, B, and C each owns a one-third interest in a rental beach house which was purchased for $900,000. Assume the house generates a tax loss during the years in question and the owner's personal use is below the maximum allowed under the vacation home provisions. Assume the property was purchased near the height of the real estate market in 2007. After the subprime mortgage crisis, the value of the property declined dramatically and is still under water today. B would like to get out and A and C agree to buy out B. Assume B realizes a loss $100,000 from the sale of B's interest. B also has a $40,000 suspended loss at the time of the sale and no other capital gains or losses. If the property is owned by an LLC treated as a partnership, a partnership interest is a capital asset. As a result, B is able to deduct only $3,000 of the capital loss in the year of sale. The $40,000 suspended loss is fully deductible. If the property is co-owned, real estate rental property is treated as a trade or business asset. If B has no other trade or business gains and losses, the entire $100,000 loss is deductible in the year of sale as a trade or business loss. The $40,000 suspended loss also is fully deductible. Big Advantage – Co-ownership.

Example 2: Assume the same facts as in Example 1 except the property increased in value and B realizes a gain of $100,000. If the property is owned by an LLC, the entire gain is considered long-term capital gain. If the property interest is owned as a co-owner, B's gain is considered a trade or business gain. Most of the gain is subject to the long-term capital gain rates (20% or 15% if B's income is below the 20% threshold ($425,800 for single and $479,000 for joint)). To the extent that a portion of the gain is attributable to depreciation deductions (unrecaptured Section 1250 gain), the gain is subject to a maximum capital gain tax rate of 25%. The $40,000 suspended loss is fully deductible. Slight to Moderate Advantage – LLC.

Example 3: Assume the same facts as in Example 2 except B would like to engage in a like-kind exchange. If the property is held by the LLC, an LLC interest does not qualify as like-kind property. If the property is held as co-owners, B could engage in a deferred like-kind exchange. He could transfer the relinquished property to A and C and acquire replacement property within set time limits (identify one or more qualified properties within 45 days after the relinquished property was transferred to A and C acquire one or more of the identified properties within 180 days). Both the $100,000 gain and the $40,000 suspended loss would be deferred. Big Advantage – Co-ownership.

Example 4: Assume the same facts as in Example 1 except A is B's brother and A buy's out B's entire interest in the property. This example is more of an issue of related party transactions rather than LLC versus co-ownership. It is a disastrous result to B as Sections 267 and 469 prevent any current loss deduction to B. Related parties under Section 267 include brothers. B's loss from a sale to a related party is not deductible. To make matters worse, Section 469(g) prevents B from recognizing the $40,000 suspended loss until his former interest is acquired by someone other than a related party. ***Note:*** *If B had sold his interest to C, who is not related to B, the results in Example 1 would apply.*

From the above examples, it appears that disposing of the property held as co-owners has significant tax advantages over holding it in an LLC. However, there are significant liability risks of holding the property as co-owners. To moderate the risk, the property could be adequately insured and perhaps an umbrella policy could be added to the insurance coverage. The nature of the rental property also should be considered. If it is property leased to an individual as his/her residence in a long-term lease, there is less liability exposure than if it is vacation rental property where it is leased on a weekly basis to a number of tenants each year.

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

10. D owes $30,000 to C and has $40,000 of other liabilities. The fair market value of D's assets is $60,000. C discharges D's $30,000 debt for C's payment of $9,000. How much is D able to exclude from gross income?
    a. $21,000.
    b. $10,000.
    c. $ -0-.

11. Assume a taxpayer in the highest tax bracket sells a 25% interest in real estate rental property at a gain. Would he incur more, less, or the same amount of income tax, if he owned the interest as a co-owner compared to if he owned it as an LLC member taxed as a partnership?
    a. More.
    b. Less.
    c. Same.

Solutions

10. **"B" is the correct response**. D has $21,000 of cancelled debt ($30,000 - $9,000). D was insolvent to the extent of $10,000 before C cancelled $21,000 of D's debt to C ($30,000 + $40,000 - $60,000). Under the insolvency exclusion provision, $10,000 of the $21,000 may be excluded from gross income.
    "A" is an incorrect response. $21,000 is the amount of debt cancelled, which generally would be included in gross income. But, to the extent of D's insolvency before the debt cancellation, that much of the debt cancellation may be excluded from gross income.
    "C" is an incorrect response. $-0- of the $21,000 cancelled debt may be excluded from gross income if the taxpayer was not insolvent. *Special Topics – Basic Review of Cancellation of Debt.*

11. **"A" is the correct response**. The 25% maximum tax rate on unrecaptured Section 1250 gain is greater than the 20% normal tax rate on capital gains. A sale of real estate rental property as a co-owner will result in unrecaptured Section 1250 gain whereas a sale of an LLC interest will not.
    "B" is an incorrect response. Since unrecaptured Section 1250 gain would be taxed at a higher rate, he would not incur less tax selling the property as a co-owner compared to through an LLC interest.
    "C" is an incorrect response. If the taxpayer's tax rate had been less than the capital gains tax rate, the tax on each sale would be the same. *Special Topics – Some Tax Differences in Disposing of Real Estate Rental Property Held as Co-owners Versus Through an LLC Interest.*

[ITEM 19] AN ELITE POSSIBILITY

The basic exclusion amount for determining the unified credit against the estate tax is $11.18 million. If a deceased spouse's taxable estate is less than the credit, the unused credit may be transferred to the surviving spouse. In order for the surviving spouse to be entitled to the deceased spouse's unused exemption (DSUE], the executor of the estate must make an election under Section 2010(c)(5)(A). This is known as the "portability election." Treasury Regulation 20.2010-2(a)(3) states: "the executor of the estate of a decedent survived by a spouse will not make or be considered to make the portability

election if either of the following applies: (I) the executor states affirmatively on a timely filed estate tax return, or in an attachment to that estate tax return, that the estate is not electing portability under Section 2010(c)(5), or (ii) the executor does not timely file an estate tax return. One might ask why would the executor or personal representative not want to make the election? In most cases, where the spouses have been happily married and each spouse has financially and emotionally supported each other, this would not be an issue. However, consider a second marriage which has not turned out so well and the children from each parent also may be at odds. Perhaps there has been spousal abuse, cheating, or otherwise not living up to the financial or emotional obligations expected in the marriage. If the assets of one spouse are significantly above the unified credit amount and the assets of the other spouse are sufficiently below this amount, there may be significant pressure placed by the wealthier spouse on the spouse with the potential DSUE to provide for the election in the latter spouse's will. What if the spouse refuses and later dies before the wealthier spouse? Can the surviving spouse require the personal representative of the decedent's estate to make the DSUE election? Based on the Code and regulations, it would seem unlikely. However, in an Oklahoma Supreme Court case [Vose, 2017 OK 3, Case Number: 115424,1/17/2017], the court affirmed a district court decision which ordered the administrator (decedent's son) to make the portability election. The decedent's son appealed the decision in the district court based on the following grounds: (1) the district court lacked subject matter jurisdiction; (2) its order concerning the DSUE is preempted by federal law; (3) the trial court failed to properly consider the antenuptial agreement and therefore erroneously determined the surviving spouse had standing; and, (4) the district court's order violates the terms of the antenuptial agreement. The surviving spouse was the decedent's second husband and was not an heir to her estate, a point the decedent's son raised in his claim that the surviving spouse lacked standing. The State Supreme Court ruled the surviving spouse had a beneficial interest in the estate arising from the DSUE. Therefore, it ruled he had standing. It noted that the portable DSUE is not simple property acquired by one party over the course of the marriage according to existing laws in effect when the agreement was made. It is an interest created by the Internal Revenue Code that was an impossibility at the time the antenuptial agreement between the spouse and decedent was created. The preemption doctrine is also known as the "Supremacy Clause." Article VI, Clause 2 of the Constitution essentially states that where federal and state law differ, federal law prevails. The Oklahoma Supreme Court concluded that the preemption doctrine did not apply under the following rationale: "The fact that state law may restrict a choice granted by federal law does not necessarily implicate the preemption doctrine by thwarting the objective and purpose of the law." However, when there are only two choices (making the portability election or not making it), it seems that limiting one of the two choices mandates the other choice, thereby violating the Supremacy Clause. Nevertheless, the court affirmed the District Court and required that the election be made.

Note: Although one state's law is not binding in other states or in federal law, this case should be considered during estate planning. Some commentators consider the DSUE to be an asset of the estate and a contingent asset during a spouse's lifetime. To that end, with proper planning, a spouse in a troubled marriage could use the DSUE to his or her benefit. Specifically, an agreement could be made between the two spouses that if the DSUE were available at the time of death of one of the spouses, some consideration would be paid by the surviving spouse to the decedent's estate. Given the top estate tax rate of 40% and a maximum credit of $11.18 million in 2018, the value of a DSUE to a surviving spouse could be substantial. If the parties cannot come to an agreement during their lifetime, a spouse who is likely to have a DSUE should include a directive in his/her will to make or not make the portability election. In the Vose case, there was no such directive. Perhaps a monetary amount could be stated in the will before the election would be made. Given the doubling of the unified credit in 2018 and the number of second marriages, this issue is likely to arise in the courts in the near future.

****REVIEW QUESTION AND SOLUTION****

12. On the basis of this issue's Elite Possibility and a recent court case dealing with the portability election, **which one** of the following statements **is true**?
    a. The decedent's will directed the personal representative to forgo the election.
    b. The court ruled that the preemption doctrine (Supremacy Clause) did not apply in this case.
    c. The antenuptial agreement required both spouses to waive the portability election.

Solution

12. **"B" is the correct response**. The court concluded that a state restriction of a choice granted by federal law does not necessarily implicate the preemption doctrine.
    "A" is an incorrect response. The decedent's will was silent with respect to whether the portability election should be made.
    "C" is an incorrect response. The antenuptial agreement was signed years before the portability election became law. *An Elite Possibility and Vose.*

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******* EXAM QUESTIONS *******

*Place your answers to the following 20 Multiple Choice Questions on the enclosed answer sheet (**page 21**).*

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1. At the beginning of 2018, a taxpayer purchased his principal residence for $950,000, which is its current value. He has a first mortgage on the residence that has a balance of $700,000. Near the end of the year, he took out a home equity loan on his principal residence of $100,000 which was used to make substantial improvements to a second home. It now is worth $225,000. There are no loans on the second home. How much of the $800,000 in total debt qualifies as acquisition debt in 2018?
   a. $800,000.
   b. $750,000.
   c. $700,000.

2. **Which one** of the following groups **is not** a group the IRS recommends to check their 2018 withholding with its "Withholding Calculator" because of the "Tax Cuts and Jobs Act" changes?
   a. Those who work two or more jobs.
   b. Those who have children and claim credits.
   c. Nonresident aliens.

3. Regarding the Work Opportunity Tax Credit (WOTC), **which one** of the following responses **is true**?
   a. Summer youth employees who live in Empowerment Zones are not a WOTC-eligible worker.
   b. Tax-exempt organizations in no case qualify for the credit.
   c. An eligible work group is long-term unemployment recipients who had been unemployed a period of at least 27 weeks and received state or federal unemployment benefits part or all of the 27-week period.

4. Regarding a recent IRS item dealing with members of the armed forces serving in the Sinai Peninsula, **which one** of the following statements **is false**?
   a. A service member who served in the Sinai Peninsula during the last four months of 2015 is **not** eligible to claim combat zone benefits.
   b. Combat pay received in 2018 will be correctly reported on any W-2 forms issued to any service member who serves in the Sinai Peninsula.
   c. Eligible service members who are unable to secure a corrected W-2 (Form W-2c) may provide other documentation to prove they served in the Sinai Peninsula.

5. A taxpayer purchases a light-duty truck for $28,000 in March 2018. Assuming it is used 100% for business in 2018 and it is placed into service in March 2018, what is the maximum depreciation deduction in 2018 assuming the taxpayer claims bonus depreciation?
   a. $10,000.
   b. $18,000.
   c. $16,400.

6. **Which one** of the following **is not** on the IRS's 2018 list of "Dirty Dozen" tax scams?
   a. Offshore tax avoidance.
   b. Fake charities.
   c. Conservation easement charitable contributions.

7. Regarding the IRS's "Offshore Voluntary Disclosure Program," **which one** of the following responses **is false**?
   a. In addition to the disclosure program, the IRS uses delinquent international information return submission procedures to monitor the proper reporting of foreign financial assets.
   b. The IRS's success with the program resulted in its decision to continue the program indefinitely.
   c. Besides voluntary disclosure, the IRS uses taxpayer education and whistleblower leads to combat offshore tax avoidance. *IR-2018-52*.

8. Regarding virtual currency transactions, **which one** of the following responses **is true**?
   a. A sale of virtual currency results in a Section 1231 gain or loss.
   b. Virtual currency payments made to independent contractors generally are subject to the self-employment tax rules.
   c. Wages paid to employees using virtual currency are not subject to W-2 reporting.

9. Regarding certain 2018 inflation adjustments and corporate tax calculations in 2018, **which one** of the following statements **is true**?
   a. C Corporations with fiscal years ending in 2018 are not eligible for the 21% tax rate until 2019.
   b. The foreign income exclusion in 2018 is $103,900.
   c. The 2018 amount used to determine the phaseout of the AMT exemption for estates and trusts is $500,000.

10. Regarding a recent case where property was improved over a number of years and ultimately was sold, **which one** of the following **was not** a fact in the case?
   a. The owners never rented the property.
   b. The owners obtained state and federal tax credits to help with restoration costs.
   c. The owners originally claimed a capital loss on the sale of the property.

11. In a recent Tax Court case dealing with the character of gain from the sale of land, **which one** of the following statements **is false**?
   a. The IRS claimed that the extent of development of the parcels shows that these properties were held primarily for sale in the ordinary course of business.
   b. The fact that the taxpayer was to receive additional payments when a plat was recorded or when a home sale closed played no major role in the Tax Court's determination.
   c. The taxpayers had every intention to develop the land at the time the buyer approached the taxpayer about purchasing the land.

12. In a recent court case involving the forfeiture of a nonrefundable deposit, **which one** of the following **was a major factor** in the court's reaching its decision?
   a. The underlying property which was to be sold was not a capital asset under Section 1234A.
   b. The character of a gain from a forfeiture of any nonrefundable deposit on a pending sale is the same as the underlying property which was to be sold.
   c. The relevant statute requires ordinary income tax treatment for all forfeited payments received from a

terminated sales contract.

13. A taxpayer purchases a home in part with nonrecourse debt. She converts it to rental property when the home's fair market value is $500,000, and shortly after sells it in a short sale in a real estate market that has turned down. She receives $250,000 of sales proceeds which she turns over to the lender. At the sale date, the debt balance is $600,000, and her basis in the home is $675,000. Based on a recent decision by the Tax Court, what are the income tax consequences to the taxpayer?
    a. No gain or loss on sale, and no cancellation of debt income.
    b. $425,000 deductible loss, and $350,000 of cancellation of debt income.
    c. No gain or loss on sale, and $350,000 of cancellation of debt income.

14. For a recent innocent spouse case, the Tax Court examined seven factors to determine if the taxpayer / husband qualified for innocent spouse relief under Section 6015(f). **Which one** of the following **was not** one of the factors?
    a. Whether there were erroneous items reported on the joint return.
    b. Whether the taxpayer would suffer economic hardship if required to pay the unpaid tax liability.
    c. Whether the taxpayer received a significant benefit from the unpaid tax liability.

15. **Which one** of the following **was a finding** in a recent TIGTA investigation involving employee identity theft victims?
    a. A substantial number of employee identity theft victims had not been notified at the time of the investigation.
    b. For taxpayers who were notified, over 50% of the notices were erroneous.
    c. Most of the victims' bank accounts were hacked.

16. For the cancellation of debt exception and exclusion provisions, **which one** of the following statements **is false**?
    a. Debt cancelled as a gift generally results in cancellation of debt income for the gift recipient.
    b. For the insolvency exclusion, the amount of cancelled debt excluded from gross income cannot exceed the amount by which the taxpayer/debtor is insolvent immediately before the debt is discharged.
    c. The "qualified real property business debt" exclusion is not available to a C Corporation.

17. For a recent case involving forgiveness of student loan debt which was borrowed by the student's parents, **which one** of the following responses **is true**?
    a. The parent's CPA advised them that because of their insolvency, they did not have to report any cancellation of debt in their gross income.
    b. The court first examined federal law to determine if the son held his parents' savings account as his parents' nominee.
    c. The court found that the son's mother did not exercise dominion and control over the savings account.

18. Based on the Special Topics section which contrasts the tax consequences of disposing of real estate rental property as co-owners versus in an LLC taxed as a partnership, **which one** of the following statements **is true**?
    a. Co-owners have greater liability protection than LLCs.
    b. If an owner disposes of her interest at a gain, she will always pay less income tax if the property were owned as a co-owner than if it were owned as an LLC interest.
    c. A co-owner may exchange his interest in the property under the like-kind exchange rules.

19. Taxpayer A realizes a $40,000 loss from the sale of his 40% interest in real estate rental property. What is the character of the loss assuming the property was held (1) as a co-owner, or (2) in an LLC taxed as a partnership?
    a. Co-ownership – Capital; LLC – Capital.
    b. Co-ownership – Ordinary; LLC – Capital.
    c. Co-ownership – Capital; LLC – Ordinary.

20. On the basis of this issue's Elite Possibility and a recent court case dealing with the portability election, **which one** of the following statements **is false**?
    a. The Code and Treasury regulations allow the executor of a decedent's estate to make or not make the portability election.
    b. A recent state supreme court required the estate's personal representative to make the portability election.
    c. Because the surviving spouse was not an heir of his spouse's estate, the state supreme court ruled that he lacked standing.

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EXAM INSTRUCTIONS AND ANSWER SHEET – Summer 2018, VOLUME XXVII, NUMBER 2, TAXATION

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[ ] Bundle [2] 2018/2017 Easy Update & Inflation Adjustments (6 CPE)

[ ] Bundle [3] Corporate Tax (2 CPE) , Partnership Tax (2 CPE) , & S Corp (3 CPE, FREE BONUS HOUR**)**

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THE ELITE QUARTERLY NEWSLETTER – 4 CPE Credit – [Update]

Quarterly Newsletters devoted to raise practitioner awareness concerning recent tax developments in legislation, the IRS, judicial decisions, and the Treasury.

ENROLLED AGENT ETHICAL STANDARDS – 2 CPE Credit – [Basic]

This course will examine the principal rules, duties and restrictions applicable to enrolled agents in their professional activities. Course learning objectives focus on instructing enrolled agents and other professionals to understand their ethical responsibilities in representing their clients before the IRS and in preparing tax returns in accordance with Circular 230.

BUNDLE [1]

AFFORDABLE CARE ACT – EMPLOYER RIGHTS AND RESPONSIBILITIES - 3 CPE Credit – [Overview]

The Patient Protection and Affordable Care Act (PPACA) has brought about the most significant change in healthcare since the passage of the 1965 legislation that authorized Medicare. It imposes healthcare-related requirements on health plans, health insurers, employers and individuals. This course will review the principal coverage provisions of the law and will examine its tax impact on employers.

EARNED INCOME CREDIT - 3 CPE Credit – [Overview]

Upon completion of this course, practitioners will be able to apply the earned income credit rules to determine if a taxpayer is eligible for the tax credit; identify the common errors committed in connection with the earned income credit; describe the consequences of the IRS' disallowance of the earned income credit; and recognize the tax return preparer's EIC due diligence requirements.

BUNDLE [2]

2018/2017 EASY UPDATE & INFLATION ADJUSTMENTS - 6 CPE Credit – [Overview]

This course examines key individual, business, retirement, and estate tax provisions recently enacted or indexed for inflation. The emphasis is on quick access to major tax changes having special meaning to the tax practitioner and return preparer.

BUNDLE [3]

CORPORATE TAXATION OVERVIEW - 2 CPE Credit – [Overview]

This course examines and explains the basics of corporate taxation. The focus is on regular or C corporations, their formation, and operation under tax law.

PARTNERSHIP TAXATION OVERVIEW- 2 CPE Credit – [Overview]

This course will examine tax issues relating to the formation and operation of partnerships. Participants will gain a familiarity with basic areas of partnership taxation so as to recognize a problem and have at hand some practical knowledge for its solution.

S CORPORATIONS OVERVIEW - 3 CPE Credit – [Overview]

In this course, the intricacies of setting up and terminating an S corporation are detailed and taxation is discussed. The numerous advantages and disadvantages of this entity are identified to help practitioners determine whether the S corporation is most suitable for their clients

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