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INDIVIDUAL TAXATION:

Taxpayer Allowed to Aggressively Allocate Cost Thereby Maximizing Energy Credits (PLR 201130003)

The IRS approved a taxpayer's approach for allocating the costs of his condensing unit between

Code §25C and **Code §25D**. The condensing unit was installed outside of the taxpayer's dwelling and operated on solar power to cool his residence. In addition, the taxpayer was permitted to include other components of his solar energy system (including a portion of the condensing unit), as "qualified solar electric property expenditures" in determining his overall credit amount under **Code §25D**.

Background on Nonbusiness Energy Property Credit: For property placed in service in tax years 2009 and 2010, a taxpayer was permitted to claim on **Form 5695** a credit equal to 30% of the sum of the cost of "qualified energy efficiency improvements" to his principal residence. In addition, 10% of "residential energy property expenditures," up to an lifetime aggregate amount of $1,500, could also be claimed as a credit. The expenses had to be made "on or in connection with a dwelling unit located in the U.S., owned and used by the taxpayer as his principal residence (as defined in **Code §121**), and originally placed in service by the taxpayer."

Meanwhile, for property placed in service in 2011, a taxpayer can claim a 10% credit for "qualified energy property" up to a $500 lifetime limit (with no more than $200 from windows and skylights) over the aggregate of the credits allowed to the taxpayer for all earlier tax years ending after Dec. 31, 2005. The credit is equal to the sum of: (1) 10% of the amount paid or incurred by the taxpayer for "qualified energy efficiency improvements" installed during the tax year, and (2) the amount of the "residential energy property expenditures" paid or incurred by the taxpayer during the tax year. (**Code §25C**) However, the maximum amount of credit allowed for any item of "energy-efficient building property" is $300.

"Residential energy property expenses" are expenses for "qualified energy property," along with related labor costs, that meet specific standards set forth in **Code §25C(d)(2)(B)** and **Code §25C(d)(2)(C)**. Among other things, "qualified energy property" includes energy-efficient building property, such as an electric heat pump water heater or central air conditioner, that meets specific energy efficiency standards. (**Code §25C(d)**)

Background on Residential Energy Efficient Property Credit: Under **Code §25D(a)(1)**, a taxpayer is permitted to claim a credit for 30% of the "qualified solar electric property expenditures" (i.e., expenditures for property which uses solar energy to generate electricity for use in a dwelling unit located in the U.S. and used as a principal residence by the taxpayer) made during tax years before 2017. (**Code §25D(d)(2)**) **Code §25D(e)(1)** adds that expenditures for labor costs properly allocable to the "onsite preparation, assembly, or original installation" of the property shall be taken into account for **Code §25D** purposes.

Manufacturer's Certification: Notice 2009-41 and **Notice 2009-53** provide that manufacturers of energy and solar electric property can certify to a taxpayer that the property meets certain requirements needed to claim either the **Code §25C** and **Code §25D** credits, by providing the taxpayer with a certification statement that satisfies certain requirements. The manufacturer can provide the certification statement by including a written copy of the statement with the packaging of the property, in printable form on the manufacturer's website, or in any other manner that will allow the taxpayer to retain the certification statement for tax recordkeeping purposes. With limited exceptions, a taxpayer may rely on a manufacturer's certification in determining whether energy property is eligible for the **Code §25C** and **Code §25D** credits.

Facts: Taxpayer purchased and installed on his principal residence a Solar Energy System which generated electricity for his personal use at his principal residence. The system included the following components:

- Solar Panels, which capture solar energy and are installed on the roof of the dwelling;

- Solar Sub Panel, which routes solar-generated electricity from the Solar Panels to an outdoor air conditioning condensing unit (the Condensing Unit);

- Condensing Unit, which is installed outside the dwelling and operates on solar power to cool the residence; and

- Wiring Components, including an A/C System Kit and Rooftop Junction Box, that connect the Solar Panels to the Condensing Unit and are also used to install multiple Solar Panels to the roof.

The manufacturer determined that a percentage of the cost of the Condensing Unit was attributable to costs that were allocable to the generation of solar energy and use of this solar energy in the taxpayer's dwelling. This percentage was determined by totaling the costs of the Condensing Unit that were attributable to special modifications that allow it to operate with the system, relative to the total cost of the Condensing Unit. The manufacturer also represented that eligible labor costs for **Code §25D** purposes included the costs to install the various components of the system, as well as the costs to prepare for the system's installation.

As a result of the representations made by the manufacturer, the taxpayer wanted to allocate the cost of the Condensing Unit between costs that were eligible under **Code §25C** and **Code §25D** based on the percentages provided by the manufacturer. The taxpayer also sought to allocate any related labor costs for the Condensing Unit that were "directly connected to or required for the installation" using the same ratio as determined by the manufacturer's suggested approach. Meanwhile, all other costs associated with the Solar Energy System (including any directly connected or required labor costs) would be treated as "qualified solar electric property expenditures" under **Code §25D**.

IRS Ruling: The IRS ruled that manufacturer's suggested approach of allocating the costs of the

Condensing Unit between **Code §25C** and **Code §25D**, including associated labor costs, was an "acceptable method." However, in order to claim a portion of the Condensing Unit as "qualified energy property," the taxpayer would still need to meet all **Code §25C** requirements, including the efficiency requirements for a central air conditioner in **Code §25C(d)(3)(C)**. However, in this regard (as outlined in **Notice 2009-53**), the taxpayer is permitted to rely on the manufacturer's certification that a portion of the Condensing Unit is "qualified energy property" under **Code §25C**. The IRS also took note of the distinction between labor costs for **Code §25C** and **Code §25D** purposes. Expenditures for the labor costs that are allocable to the on-site preparation, assembly, or original installation of the qualified solar electric property and for piping or wiring to interconnect such property to the dwelling unit are eligible under **Code §25D**. However, for purposes of **Code §25C**, only the labor costs for the on-site preparation, assembly, or original installation of "residential energy property" are eligible for the credit.

In addition, the IRS concluded that the taxpayer was allowed to take into account the listed components of the Solar Energy System, including a portion of the Condensing Unit, as "qualified solar electric property expenditures" for purposes of the "residential energy efficient property" credit under **Code §25D**. But, to the extent allowed under **Notice 2009-41**, the taxpayer may rely on manufacturer's certification that the components of the Solar Energy System are "qualified residential energy efficient property" under **Code §25D**. **(Code §25D; Energy Tax Credit)**

Constructive Distribution Resulted on Termination of Life Insurance Policy (*Ledger*, TC Memo 2011-183 (8/2/2011))

A taxpayer recognized taxable income on the maturity of his life insurance policy when the insurance company was forced to apply the policy's maturity value against the outstanding balance of his loans secured by the policy. In other words, this constructive distribution was deemed to be a payment of the policy proceeds that had to be treated as gross income to the extent it exceeded the taxpayer's investment in the contract.

Background: An amount received under a life insurance contract that is *not* received as an annuity is included in gross income to the extent it exceeds the investment in the contract. (**Code §72(e)(1)(A), Code §72(e)(5)(A), Code §72(e)(5)(C)**) One's "investment in the contract" is as of any date is equal to the aggregate amount of premiums or other consideration paid for the contract before that date, less the aggregate amount received under the contract before that date to the extent that amount was *excludible* from gross income. (**Code §72(e)(6)**) Meanwhile, loans against a life insurance contract's cash value are treated "as true loans from the insurance company to the policyholder with the policy serving as collateral." As a result, using a policy's proceeds to satisfy a loan is treated that same as if the proceeds were paid directly to the policyholder. (***Minnis*, 71 TC 1049 (1979), *Sanders*, TC Memo 2010-279 (12/20/2010)**)

Facts: In April of '74, the taxpayer purchased a life insurance policy, payable on either his death or his reaching age 65, from Prudential Insurance Co. of America (Prudential). The face amount of the policy was $31,448, the maturity value considered for gain was $61,722, and the endowment maturity value was $42,403. The monthly premiums were $100. In October of '78, the taxpayer borrowed $2,000 against the policy. Over the next 27 years or so, he took out an additional 13 loans against the policy. As of May 27, 2005, his final loan balance and accrued interest against the policy totaled $56,220. The policy then matured on Apr. 12, 2006, with a gross maturity value of $61,788, and a maturity value considered for gain value of $61,772. Prudential paid Ledger $5,568 (gross maturity value less final loan balance). Prudential determined the taxpayer's investment in the contract at the time of maturity to be $20,780.

For the 2006 tax year, Prudential issued the taxpayer a **Form 1099-R** that identified taxable distributions of $40,992 (i.e., the maturity value used for gain purposes, less cost basis). As a follow-up at the taxpayer's request, Prudential then sent a letter dated Mar. 9, 2010 which explained how it calculated his cost basis and taxable distributions in the policy. It confirmed that a Form 1099-R distribution of $4,435 for the '90 taxable year had been made. But, the letter did *not* indicate that any additional Forms 1099 had been issued to him during the term of the policy. It further indicated that the policy's premiums were paid using the annual dividends from '96 to 2005.

On Dec. 15, 2008, the IRS issued a notice of deficiency to the taxpayer, determining a $7,184 deficiency in income tax and a **Code §6662(a)** accuracy-related penalty of $1,433 for the 2006 tax year. The taxpayer then challenged the IRS in Tax Court, contending that he should *not* be taxed on any distribution from Prudential in 2006 because he had already paid taxes on all of the funds paid out to him under the policy.

Tax Court Decision: The Tax Court agreed with the Service that the taxpayer had in fact received $40,992 as a constructive distribution, taxable as income in his 2006 tax year. Upon termination in 2006, the policy's cash surrender value (also know as the "interpolated terminal reserve value" or CSV) for tax purposes was $61,772, while the taxpayer's investment in the policy was only $20,780. And, when Prudential terminated the policy in 2006, it applied the policy's maturity value against the outstanding balance on the policy loans. The Tax Court agreed that this was the "economic equivalent" of Prudential's paying the taxpayer the policy proceeds, including the "untaxed inside buildup," with the taxpayer "using most of those proceeds to pay off the policy loans." The bottom line was that this constructive distribution was a treated as a payment of the policy proceeds and therefore was gross income to the extent it exceeds the taxpayer's investment in the contract. **(Code §72; Insurance Proceeds)**

☞**Interest Expense Deduction Controlled by How Funds Used (*James Ellington*, TC Memo 2011-193 (8/11/2011))**

Under **Temp. Reg. §1.163-8T**, interest expense must be traced based on how the borrowed funds are actually used. In this case, the taxpayers financed their home purchase by securing the loan with the residence serving as collateral, as well as Intel Corp. stock worth $650,000 at the time of the loan. The stock was pledged in lieu of actually making a down payment, and the taxpayers attempted to deduct the portion of the loan interest attributable to the stock (i.e., based on the relative value of the respective sources of collateral used to make the purchase) as investment interest (i.e., to be claimed on Form 4952). Instead, the Tax Court denied the deduction because the *entire* loan was allocated to the purchase of a personal residence (i.e., since all the funds were distributed to the sellers of the home at the time of its purchase). **(Code §163; Interest Expense)**

> **Comment:** Since the overall cost of the residence was $1.6 million (which exceeded the $1 million cap on "qualified residence interest"), approximately 37% of the interest expense on the mortgage would be nondeductible. That is why the couple wanted to instead trace some of the interest as being "investment interest" expense so they could claim it on **Form 4952** (and, ending up on Schedule A just as any QRI would have on the first $1 million of the mortgage).

Horse Breeding Operations Found to Be Legitimate Business (*Mark Blackwell*, TC Memo 2011-188 (8/8/2011))

Even though the taxpayers "had substantial wealth and resources unrelated to their horse breeding activities, the recreational aspects were minimal." As a result, the Tax Court agreed that their horse breeding business "was carried on for profit" (i.e., under the "hobby loss" rules contained in **Code §183**). The key factors were that the husband and wife taxpayers "cautiously spent six or seven years learning about horse breeding and management before beginning their activities and proceeded after developing a comprehensive business plan." They also "performed essentially all of the horse maintenance, consulted and hired expert trainers, made adjustments in their business plan over time, and kept good books and records." As a result, even though the losses realized in the activity were substantial, the Tax Court "was convinced that the taxpayers had the potential to earn a profit." **(Code §183; Hobby Losses)**

> **Comment:** The couple here bought, bred and trained horses in addition to working regular jobs. More importantly, they had a detailed business plan and adjusted it after consulting with experts. They also used recognized horse farm accounting software, opened a separate bank account and set up a website for their breeding operations. But, after several years of continued losses, they "prudently realized" they probably could *not* ever make a profit from their operations. So, they then decided to shut down the business. These factors, taken as a whole, convinced the Tax Court that they had a profit motive and their breeding operation was more than just a hobby.

> **Comment:** Compare this case to another horse breeding investment where the taxpayer, instead of "getting his own hands dirty," let other third parties do the work for him by investing in a tax shelter deal that was intended to create large up-front losses before the mares were to be sold at a profit. The Tax Court had no problem denying his claimed breeding losses (***Van Wickler*, TC Memo. 2011-196 (8/15/2011)**).

☞**9th Circuit Confirms "Personal Goodwill" Involved in Sale of PSC Was Really Corporate-Owned Asset (*Larry E. Howard v. U.S.*, 98 AFTR 2d ¶ 2011-5226 (9th Cir., 8/29/2011))**

The 9th Circuit has affirmed a district court's conclusion that the amount received by a dentist on the sale of his wholly-owned dental practice PSC that was allocated to his "personal goodwill" was, in fact, a *corporate* asset. As a result, the amount was recharacterized as part of the overall proceeds allocable to his corporation upon the sales of all of its assets (i.e., it had to be included in the gross income on the final Form 1120 corporate return, resulting in "double taxation").

Facts: In '80, Dr. Larry E. Howard, who practiced dentistry, incorporated his practice as Larry E. Howard, D.D.S. (Howard Corporation) and was its sole shareholder, officer, and director. And, even though he was the only professional involved with this dental practice, he nevertheless entered into an employment agreement which included a covenant-not-to-compete with his corporation. Under the terms of the covenant, it would last as long as he held any stock of the corporation, plus three years thereafter. Then, in 2002, Dr. Howard and Howard Corporation sold the practice to another dental corporation. In that agreement (i.e., the Asset Purchase Agreement), Dr. Howard was specifically allocated $549,900 for his "personal goodwill," along with an additional $16,000 for a covenant-not-to-compete with purchasing corporation. On the other hand, Howard Corporation received $47,90 for its assets.

A joint return was filed for 2002 reporting $320,358 as long-term capital gain income from the sale of his "personal goodwill." However, on a subsequent audit, the IRS recharacterized the sale of the goodwill as a *corporate* asset. Therefore, when Dr. Howard received the proceeds directly on the sale, the Service insisted that they should instead be treated as part of the liquidation proceeds (i.e., an additional $320,358) flowing from the sale of the corporation's assets (i.e., and, under **Code §331**, then applied against the basis of his terminated shares, resulting in a typical "double taxation" situation). If this was the correct approach, at least from a tax standpoint, it would have resulted in a $60,129 deficiency, along with $14,792 in interest. Dr.

Howard paid the amount, filed a refund claim, and subsequently sued for a refund.

District Court Decision: Due to the covenant-not-to-compete that Dr. Howard had with his company, the district court concluded that the goodwill generated over the 23 years that he was an employee (i.e., 1980 to 2002) should be treated as a *corporate* asset. Therefore, the Howards were *not* entitled to a refund for the 2002 tax year. As to Dr. Howard's contention that the 2002 Asset Purchase Agreement terminated the '80 covenant-not-to-compete, the court noted that even if that was so, it would *not* change the characterization of the goodwill that was generated from '80 through 2002.

9th Circuit Decision: The 9th Circuit stressed the obvious point that Dr. Howard worked for the Howard Corporation under an employment contract "that obligated him to practice dentistry solely as its employee and devote his entire professional time to its affairs." Therefore, his corporation was deemed to "have retained complete control and authority regarding the acceptance or refusal of any client and all of their files and other client records." In addition, Dr. Howard (for some unfathomable reason) agreed in writing *not* to compete with his corporation as long as he held stock in it (as well as for three years thereafter). As a result, the 9th Circuit had no problem also concluding that "while the relationships that Dr. Howard developed with his patients may be accurately described as personal, the economic value of those relationships did *not* belong to him because he had conveyed control of them to the Howard Corporation." **(Code §§336 & 331; Personal Goodwill)**

> **Comment:** If Dr. Howard had come into a practice that had multiple shareholders who over a period of time ultimately retired, thereby leaving him as the sole shareholder, then maybe having a covenant-not-to-compete (at least initially) might have been understandable. But, why would he ever have such a covenant when he was the sole owner (and, only professional employee) over the life of the corporation?

NOL Carryback & Carryover Rules Cannot Be Ignored (*Hall*, FedCl, No. 10-284T (8/9/2011))

The Court of Federal Claims in this instance had no problem rejecting the taxpayer's approach to an NOL calculation which ignored the normal 2-year carryback and 20-year carryover rules.

Background: An NOL is available when a taxpayer's nonpersonal (i.e., business) deductible expenses for the tax year exceed gross income. S corps generally cannot claim an NOL. However, S corp shareholders can use their distributive share of S corp business income and deductions to figure their own NOL.

Facts: A married couple operated their business as an S corp. They were the sole shareholders of the S corp. As individual taxpayers, they reported losses for tax years 1988, 1989, 1990, 1991, 1996, and 2001 and reported taxable income in 1992, 1993, 1995, 1997, 1998, 2000, and 2003. In 2007, the couple filed amended returns for the years in which they reported losses, which purportedly generated more than $700,000 in NOLs. The taxpayers then applied all of the NOLs to their 2003 taxable income and claimed a refund of $225,000. The IRS denied the refund.

Claims Court Decision: The Claims Court affirmed the rules regarding the carrying back or forward of NOLs. Namely, an NOL is carried back to two years before the NOL year, then to the year immediately before the NOL year. After that it is carried to the first year after the NOL. Then, it is carried to each subsequent year through the 20th year. Finally, the process is terminated at the earlier of: (1) the end of the 20-year carryforward period; or (2) whenever the NOL is exhausted.

> **Comment:** The carryover or carryback of any NOL involves multiple tax years. And, generally, each year is treated as governed by the law in effect in that year.

In this instance, the taxpayers attempted to collect all of their NOLs from 1988 through 2002 and then sought to have them apply solely against their 2003 income (i.e., without ever having gone through the mandated process of carrybacks first and then carryovers). Also, the taxpayers sought to *retroactively* waive the carryback periods for the NOLs. However, **Code §172(b)(3)** provides that any waiver was required to have been made by the due date of each relevant tax year. **(Code §172; NOLs)**

> **Comment:** If a return is filed without a formal election to forgo the carryback period, an election can still be made on an amended return filed within six months of the due date of the original return. However, as seen in this case, other retroactive waivers of the carryback are *not* permitted.

☞Short-Term Rentals Treated as "Trades or Businesses" for PAL Rules (*Jende*, TC Summ. Op. 2011-82 (7/6/2011))

The legislative regs that are the "backbone" of the passive loss rules are very clear when it comes to "short-term rentals" of real estate (i.e., where the average rental period is 7 days or less). Yet, taxpayers (and, their professional preparers) do *not* seem to be aware that the status of such rentals is "elevated" to that of a "trade or business," at least when it comes to applying the passive loss restrictions.

> **Comment:** Just because a short-term rental activity is now being treated as a "trade or business" for purposes of the Code §469 passive loss rules does *not* mean that this rental is now to be reported on a Schedule C v. the normal Schedule E approach for rental real estate. Nor, does it mean that self-employment tax would be owed on any net rental income.

What it does mean is that a "higher" level of participation must now be met in order to avoid the PAL rules. Namely, the taxpayer must "materially participate" (i.e., under any one of the seven "tests" spelled out in **Code §469**) in this "trade or business" v. merely "actively participating" (i.e., just doing those duties which would normally be expected of a landlord owning rental property) in what would have been a "rental activity." And, since it is now a "trade or business" for purposes of the passive loss rules, the $25,000 "active rental real estate exception" (i.e., for those taxpayers filing under any status except "married filing separately" who also have less than $150,000 of modified AGI) would no longer be available.

Here, a couple rented out several property units that each had rental periods averaging seven days or less. They also used a property management company to find tenants, collect rents, perform maintenance and other related activities. The taxpayers did visit the properties occasionally in order to buy items for the units and make repairs. But, when it came to the "material participation" tests, the couple failed to show that they put in at least 100 or more hours a year on each unit, and that their participation was more than anyone else involved with the properties. As an alternative, they could have proven (i.e., the IRS almost always insists on an actual log of their hours for this) that they instead met the 500-hour test. But, the couple did *not* satisfy either test, so their net rental losses remained suspended on **Form 8582** due to the lack of sufficient passive income to offset them.

Comment: Under the PAL "disposition" rule, a taxpayer is always assured of eventually getting the use of any suspended losses. However, it is essentially a matter of timing as to when the tax benefit of the PAL losses will be realized by the taxpayer. Remember, the taxpayer must dispose of their "entire" PAL interest in a "fully taxable" (v. tax-deferred) transaction to have the disposition rule apply. **(Code §469; PALs)**

Payments Made to Help Ex-Wife Refinance Mortgage Not Deductible Alimony (*Grosjean*, TC Summ. Op. 2011-75 (6/27/2011))

The Tax Court confirmed that a payment made to help an ex-wife refinance a mortgage could *not* be treated as deductible alimony. Under a couple's divorce agreement, the ex-husband was ordered to pay the mortgage on the former marital home until their two children turned 19 or moved out. His ex-wife was also required to refinance the mortgage in order that his name could be taken off the loan. But, she could *not* independently qualify for that large of a mortgage, so the taxpayer paid her $50,000 which enabled her to get the loan. Agreeing with the IRS' determination, since the payment was *not* technically required by the court order, it cannot be considered "alimony." **(Code §71; Alimony)**

Comment: The mortgage payments he was making should have also failed to qualify as alimony, since they would be terminated when the kids turned 19. However, the IRS auditors apparently missed this issue.

Grant of Permanent Easement Treated as Partial Sale (*Wickersham*, TC Memo. 2011-178 (7/28/2011))

The Tax Court confirmed that a couple's grant of a permanent easement should be treated as a partial sale of the underlying property. The taxpayers owned land on which they had their primary residence, as well as a towing business. When the county insisted on putting a road through their parcel, they eventually sold the county an easement for $131,000. But, as a condition of the contract, trailers, vehicles and other items had to be removed from the land. The Court concluded that their use of the land was "substantially reduced" and, thus, the easement should be treated as sale of a property interest for $131,000. **(Code §121; Easements)**

Comment: Since their primary residence was also located on the land, the gain could be partially allocated to this portion, thereby resulting in a **Code §121** exclusion.

Comment: The question remains that if the couple was forced to sell this portion of the land under threat of eminent domain, why couldn't the remainder of the gain (i.e., the portion *not* covered under the home sale exclusion) be deferred pursuant to the involuntary conversion provision of **Code §1033**?

S CORPORATIONS:

☞**Noncompete Covenant Amortizable Over 15 Years (*Recovery Group, Inc. v. Commr.*, 108 AFTR 2d 2011-XXXX (1st Cir., 7/26/2011))**

An S corporation agreed to redeem a 23% shareholder's stock for $255,908 plus a $400,000 for a one-year covenant-not-to-compete. The taxpayers (i.e., an S corporation plus 13 shareholders) argued that the covenant was *not* subject to **Code §197**, thereby making it fully deductible over its one-year life. The IRS countered that the covenant was a Section 197 intangible asset amortizable over 15 years, beginning with the month of the acquisition. In affirming the Tax Court's decision that the covenant should be treated as 15-year amortizable property, the 1st Circuit concluded that **Code §197(d)(1)(E)** (which includes a covenant-not-to-compete in the list of Section 197 intangibles) "includes any covenant-not-to-compete entered into in connection with the acquisition of any shares (substantial or not) of stock in a corporation that is engaged in a trade or business." In other words, Congress intended **Code §197(d)(1)(E)** to apply to any stock acquisition, *not* just stock acquisitions that are considered "substantial." **(Code §197; Noncompete Covenants)**

S Corp Distributions Resulted in LTCGs (*Miller*, TC Memo 2011-189 (8/9/2011))

An S corporation shareholder, who had given most of his stock to his son in the previous year, had long-term gain on distributions made from the S corporation to him because they exceeded his remaining basis in his S corporation stock (i.e., after the gift was completed).

Background: Under **Code §1366(a)(1)**, an S corporation shareholder takes into account their pro rata share of the S corporation's items of income, loss, deduction, or credit for the S corporation's tax year ending with or in the shareholder's tax year. Under **Code §1367**, a shareholder's basis in the S corporation stock is increased by income passed through to the shareholder under **Code §1366(a)(1)**, and decreased by, among other items, distributions *not* includible in the shareholder's income under **Code §1368**. The amount of a distribution from an S corporation to a shareholder equals the amount of cash distributed plus the fair market value (as of the date of distribution) of any other property distributed. (**Code §1368(a)**) If an S corporation has no accumulated E&P (which was the case here), the amount distributed reduces the shareholder's basis in his stock (along with AAA simultaneously). And, if the amount exceeds basis, the excess is treated as a payment made in exchange for the stock. As a result, distributions are *not* included in a shareholder's gross income to the extent that they do *not* exceed the adjusted basis of the shareholder's stock (but do serve to reduce basis), while any distribution amount in excess of basis is treated as gain from the sale or exchange of property (i.e., in this case, a capital asset). (**Code §1368(b)(2)**)

Facts: The taxpayer owned all the outstanding stock of an S corporation - JAM Pharmaceutical, Inc. (JAM): 10,000 shares of class A voting common stock, and 90,000 shares of class B nonvoting common stock. Although JAM's certificate of incorporation was amended on Aug. 29, 2002 to authorize the issuance of 1 million shares of each class, no such additional shares were ever issued. On Dec. 31, 2002, the taxpayer's adjusted basis in his 100,000 shares of JAM stock was $866,795 (his original basis of $200,000 plus JAM's accumulated adjustment account balance of $666,795, as of Dec. 31, 2002). A purchase agreement dated Dec. 12, 2002, that was executed by the taxpayer and his son, stated that he would sell 950,000 shares of his JAM stock (out of the 1 million JAM shares issued and authorized to be issued) to his son for $95,000. However, the closing date was never specified in the purchase agreement. The agreement further stated that the buyer's obligation to purchase was subject to conditions, including that: (1) the taxpayer would resign as JAM's director and officer on the closing date and (2) all of the JAM shares would be sold concurrently to the buyer (i.e., his son). Subsequently, the taxpayer instead gratuitously transferred (i.e., gifted) 5,000 shares of class A stock and 90,000 shares of class B stock to his son. In other words, his son did *not* pay his father $95,000 (or, anything) for the JAM stock, and Miller did *not* resign as a director and officer of JAM.

On Form 709 for 2002, filed on July 24, 2003, the taxpayer reported the transfers of JAM stock on Dec. 31, 2002 to his son as follows: (1) 5,000 shares of class A stock in which he had an adjusted basis of $43,340 with the value of the gift as $34,600; and (2) 90,000 shares of class B stock in which he had an adjusted basis of $780,116 with the value of the gift as $511,200. Meanwhile, JAM's 2003 Form 1120S, filed on Sept. 15, 2004, reported ordinary income of $366,162. On the taxpayer's K-1, JAM reported that the taxpayer now owned 5% of JAM's stock during 2003 and that his share of JAM's ordinary income for 2003 was therefore $18,308. On May 9, 2005, JAM filed an amended Form 1120S for 2003 which reported a $1,110,390 loss, with the Schedule K-1 for Miller now reporting a $55,519 loss (i.e., 5% of JAM's total loss).

Upon examination of JAM's and the taxpayer's amended 2003 returns, the IRS determined that JAM had $382,452 of ordinary income and that K-1 distributive share should be $19,123. In addition, the IRS determined that the taxpayer had also received $619,551 of distributions from JAM in 2003, $548,664 of which exceeded his basis in his JAM stock and was taxable as long-term capital gain.

Taxpayer's Position: The taxpayer argued that IRS's determination was incorrect because he did *not* give the JAM stock to his son on Dec. 31, 2002 (as was reported on his 2002 Form 709). Instead, he insisted that it was sometime later in 2003. Alternatively, he argued that he did *not* actually "give" the JAM stock to his son, but that there was a "part-sale and part-gift" transaction with his son. He contended that the $95,000 purchase price identified in the purchase agreement should be considered as being paid through the additional distributions that he received from JAM in 2003.

Tax Court Decision: The Tax Court concluded that on Dec. 31, 2002, the taxpayer had in fact made a gift of 95,000 shares of JAM stock to his son, leaving him with a 5% interest and an adjusted basis of $51,661. Accordingly, in 2003 he received distributions from JAM in excess of his JAM stock basis, resulting in a long-term capital gain. In reaching its decision, the Court rejected the taxpayer's argument that the gift of stock took place later than 2002. Some key factors were that his 2002 Form 709 reported that he gave 95% of the JAM shares to his son on Dec. 31, 2002, that no amended Form 709 was filed, that no gift was reported for 2003, and that the stock certificate stubs identified Dec. 31, 2002 as the date that 95,000 shares of JAM were issued to his son. Furthermore, JAM's 2003 Form 1120S and Miller's individual income tax return reported him as having a 5% interest in JAM. As a result, the Court refuse to accept that, after learning of the tax consequences of having made a gift in 2002 rather than 2003, that the taxpayer should be allowed to disavow his 2002 gift of 95% of the JAM stock to his son. **(Code §2501; Stock Transfers)**

ESTATES, GIFTS & TRUSTS:

Charitable Stock Transfers (PLR 201129033)
Generally speaking, a charitable deduction is disallowed under **Code §2522(c)** on the transfer of a property interest where an interest in the *same* property is retained by the donor. Nevertheless, the IRS ruled that charitable transfers of *nonvoting* stock by the taxpayers, who also held *voting* stock, were still deductible as transfers of the "entire interest in the property." According to the Service, the nonvoting stock was considered a "separate property interest" apart from the voting stock, and the shares in this one class "did *not* constitute an interest in the shares of any other class of stock." **(Code §2522; Retained Interest)**

☞Draft Form 706 for 2010 Decedents Released
The IRS has released a draft of **Form 706** for estates of decedents dying after Dec. 31, 2009 and before Jan. 1, 2011, along with its **instructions** which reflects the changes made by the 2010 Tax Relief Act, as well as indexing and other changes.

Changes on Form 706 and Instructions: The draft instructions stress that the current revision is to be used only for decedents dying in calendar year 2010. Also, they note that the 2010 Tax Relief Act included these changes affecting the 2010 Form 706:

- Estates of decedents dying in 2010 may elect to apply modified carryover basis treatment (within the meaning of **Code §1014**) to property acquired or passing from the decedent.

> **Comment:** Although *not* specifically mentioned in the instructions, by making this election, the estate also will be electing to *not* pay any zero estate tax for 2010. But, the draft instructions do *not* explain how to make the modified carryover basis/zero estate tax election. However, since the instructions were released, the Service has confirmed that the election will be made on **Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent** stating that deadline will be extended until 1/17/2012 (i.e., from the original 11/15/211 date).

- For decedents dying between Jan. 1, 2010 and Dec. 16, 2010, the original due date for Form 706 was Sept. 19 , 2011 (but an automatic 6-month extension can be requested, now making the due date 3/17/2012)).

> **Comment:** Because the form was published so close to the filing deadline, many estates will need a filing and/or payment extension, which can be obtained by filing **Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes**. However, the IRS cautions that if you are filing a request for an extension of time to file an estate or gift tax return, that the request must go to the Cincinnati Service Center, even if you file the income or other tax returns elsewhere.

- The applicable exclusion amount is $5 million.

- The maximum estate tax rate is 35%.

- The applicable rate for generation-skipping transfers is zero.

- Prior gifts must be calculated at the rate in effect at the decedent's date of death (i.e., even if the rate was higher at the time the gift was actually made).

> **Comment:** Some estate tax changes are delayed for decedents dying *after* 2010. As a result, they are *not* reflected on the draft 2010 Form 706. For example, effective for estates of decedents dying *after* 2010 and *before* 2013, the 2010 Tax Relief Act allows a deceased spouse's unused estate tax exclusion to be shifted to the surviving spouse.

Indexing Changes: The draft instructions also note that various dollar amounts and limitations involved in the preparation of Form 706 are indexed for inflation. Specifically, for decedents dying in 2010: (a) the ceiling on special-use valuation is $1 million (i.e., same as for decedents dying in 2009); and (b) the amount used in computing the 2% portion of estate tax payable in installments is $1.40 million (up from $1.33 million for decedents dying in 2009).

Executor Documentation: The final item in the "What's New" section of the Form 706 instructions is that executors must provide documentation of their status. Documentation will vary, but it may be a certified copy of the will or a court order designating the executor(s). To be clear, a mere statement by the executor attesting to his status will *not* be sufficient.

Installment Payment of Estate Taxes: The draft instructions also point out that, in 2008, the IRS added a worksheet to help executors calculate how much of the estate tax may be paid in installments under **Code §6166**.

Tax Due Date: The draft instructions state that the estate and GST taxes are due within nine months after the date of the decedent's death. They point out, however, for estates of decedents after Dec. 31, 2009 and before Jan. 1, 2011, the due date for payment was originally Sept. 19, 2011 (but, which now been extended until 3/17/2012). **(Code §2031; Form 706)**

☞Guidance Issued on "Opt-Out" Choice for Executors of 2010 Decedent Estates (Notice 2011-66)
Under §301(c) of the 2010 Tax Relief Act, estates of decedents who died in 2010 can choose zero estate tax, but then the beneficiaries would be required to take a modified carryover basis in any inherited property. (**Code §1022**) The IRS has now issued long-awaited detailed guidance on how this election is made. The guidance states that the election was to be

made by filing **Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent**, on or before Nov. 15, 2011 (but, it has now been extended until 1/17/2012).The notice also addresses various 2010 generation-skipping transfer (GST) issues. And, the Service has issued separate guidance in the form of a revenue procedure provides "safe harbor basis rules."

Comment: The IRS had previously stated that the election would be made on Form 8939 and referred to the it as the "301(c) election." Now, however, the election is supposedly going to be known as the "Section 1022 election," although specific details are still lacking.

Background: Under the 2001 Tax Relief Act (EGTRRA), the estate tax was supposed to have been repealed for individuals dying in 2010, and the rules allowing a step-up in basis for property acquired from a decedent were to have been replaced with a "modified carryover basis regime." But, the 2010 Tax Relief Act restored the estate tax for individuals dying in 2010 with a $5 million per person exemption and a maximum rate of 35%. Technically, it also repealed the modified carryover basis rules for property acquired from a decedent who died in 2010. However, §301(c) of the 2010 Tax Relief Act still allows estates of individuals dying in 2010 to elect zero estate tax and the modified carryover basis rules that would have applied before they were repealed.

Generation Skipping Transfers: Even though an executor may elect out of the estate tax, the GST tax provisions continue to apply. However, §302(c) of the 2010 Tax Relief Act provides that the applicable tax rate for each GST occurring during 2010 is zero. And, §301(d)(2) clarifies that, in the case of any generation-skipping transfer made after Dec. 31, 2009, and before Dec. 17, 2010, the due date for filing a return required under **Code §2662** (including any election required to be made on such return) was *not* to be earlier than Sept. 17, 2011 (but, has since been pushed back until 3/17/2012, as explained in **Notice 2011-76**).

Making the Election: On or before 1/17/2012 (i.e., extended from the original Nov. 15, 2011 due date), the executor of the estate of a decedent who died in 2010 may make the "Section 1022 Election" by filing a **Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent**. Once made, the election is irrevocable, subject to exceptions discussed below. Furthermore, prior filings purporting to make the Section 1022 Election must be replaced with a timely filed Form 8939. (**Notice 2011-66, §I.A.**) However, **Notice 2011-66, §I.A.** does contain detailed information on how the IRS will proceed in the event of conflicting filings, such as where there is *both* a filing of a Form 706, as well as an election on Form 8939 to use the modified carryover basis rules for the same decedent.

Methods of Allocating Basis: The executor must allocate the "basis increase," as defined in **Rev. Proc. 2011-41, §4.02**, on a timely filed Form 8939. The recipient's basis in a particular property item (which would include the amount of basis increase allocated to that property) is subject to adjustment upon the examination by the IRS "of any tax return reporting a value dependent upon the property's basis" (e.g., the property's depreciation, sale, or other disposition that triggers gain or loss on the property, or otherwise). (**Notice 2011-66, §I.B.**)

Reporting Requirements: An executor making the "Section 1022 Election" (i.e., to use the modified carryover basis rules) must report and value on Form 8939 all property (excluding cash and property that constitutes the right to receive an item of income in respect of a decedent under **Code §691**) acquired from the decedent. (**Code §6018(b)(1)**) In addition, the executor must report all appreciated property acquired from the decedent, valued as of the date of death, that was required to be included on the donor's Form 709, if the property was acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the 3-year period ending on the date of death. (**Code §6018(b)(2)**) However, this does *not* include property transferred to the decedent by his spouse, if they, themselves, had *not* acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during that *same* 3-year period.

Within 30 days after the executor files a timely filed Form 8939, he must provide a statement to each recipient acquiring property reported on that form, setting forth certain information required under **Code §6018(c)**, regardless of whether the executor allocates the "basis increase" to such property on the form. (**Code §6018(e)**) Recipients also must be timely notified of adjustments made to the basis of property reported on a Form 8939. (**Notice 2011-66, §I.C.**)

Form 8939 Due Date: According to this **Notice 2011-66**, Form 8939 was originally due Nov. 15, 2011. But, **Notice 2011-76** has now pushed back this fling deadline until 1/17/2012. A Form 8939 filed before that date may be amended or revoked, but only on a subsequent one filed on or before 1/17/2012. As a result, the Form 8939 that is considered "timely filed" by an executor is the *last* Form 8939 filed by him on or before 1/17/2012. Accordingly, the IRS will *not* grant extensions of time to file a Form 8939 and will *not* accept a Form 8939 or an amended Form 8939 filed after the 1/17/2012 due date (except in certain situations specified in **Notice 2011-66**). The bottom line, according to the IRS, is that a taxpayer is *not* permitted to file an estate tax return, as well as a conditional Form 8939, that would take effect only if an estate tax audit results in an increase in the gross estate above the applicable exclusion amount. (**Notice 2011-66, §I.D.1.**)

Relief Provisions: Apart from statutory relief provisions such as **Code §7508** and **Code §7508A** (as well as the automatically extended due dates outlined in **Notice 2011-76**), **Notice 2011-66** provides these

four types of relief from the due date requirement:

- An amended Form 8939 may be filed after the due date for the sole purpose of allocating "Spousal Property Basis Increase," as defined in **Rev. Proc. 2011-41, §4.02(3)**, among the property eligible to receive an allocation of that basis, if certain conditions are met.

- An executor who timely filed a Form 8939 (i.e., by the 1/17/2012 due date) may file an amended Form 8939 under **Reg. §301.9100-2(b)**, on or before May 15, 2012, for any purpose except to make or revoke a Section 1022 Election.

- An executor may apply for relief to supplement a timely filed Form 8939 under **Reg. §301.9100-3**.

- An executor may seek an extension of the time to file the Form 8939 under **Reg. §301.9100-3**. **(Notice 2011-66, §I.D.2.**)

GST Issues: Notice 2011-66 also deals with how a donor may elect out of the automatic allocation of GST tax exemption to direct skips occurring during 2010. It also clarifies the due dates for returns (since altered by the automatic extensions outlined in **Notice 2011-76**) for the tax year ending Dec. 31, 2010, that report a generation-skipping transfer, that allocate GST exemption, or that opt out of the automatic allocation of GST exemption. In addition, it discusses the application of the GST tax to testamentary transfers during 2010. (**Notice 2011-66, §II.**) **(Code §2031; Estate Tax)**

☞Service Provides Filing and Penalty Relief for Estates Opting Out of Estate Tax for 2010 (Notice 2011-76)

The IRS has announced that it is providing filing and penalty relief for large estates of decedents who passed away in 2010, as well as for certain beneficiaries of those estates. The relief is intended to give these estates (generally, taxable estates with over $5 million in assets that are more likely to elect out of the revived 2010 estate tax) additional time to comply with key tax law changes that were enacted late last year as part of the 2010 Tax Relief Act.

Filing Deadline for 2010 Form 706: For decedents dying between Jan. 1, 2010 and Dec. 16, 2010, the normal due date for Form 706 would be Sept. 19, 2011. And, for a decedent who died after Dec. 16, 2010, the filing deadline would be nine months after the date of death. (**Code §6075(a)**) Under **Code §6081**, the IRS may grant a filing extension *not* to exceed six months (except in the case of taxpayers who are abroad), and the IRS may similarly extend the time for payment under **Code §6161(a)**. These extensions are requested on **Form 4768**.

Extended Filing and Payment Deadlines: Due to concerns about whether executors of 2010 estates will "have sufficient time to make informed decisions" about whether or not to make a Code §1022 election, the IRS and the Treasury Department decided to grant the estates of 2010 decedents an *automatic* six-month extension of time to file the estate tax return, as well as to pay any estate tax otherwise due. Furthermore, executors of a 2010 estates are *not* required to substantiate on the Form 4768 the reason for requesting a payment extension. Nevertheless, interest will accrue under **Code §6601** on any estate tax liability from the normal due date of the return (9/19/2011, as mentioned above), excluding extensions.

> **Comment:** Except in the case of an executor abroad, the IRS is *not* permitted to grant additional extensions of time to file Form 706 or Form 706-NA. However, an executor may apply for an additional extension of time to pay the estate tax under **Code §6161** by filing a **Form 4768** on or before the extended payment due date and providing the documentation required with such form.

Waiver of Form 706 Late Payment & Filing Penalties: The IRS has been instructed *not* to impose late filing and late payment penalties under **Code §6651(a)** on estates of decedents who: (i) died after Dec. 31, 2009 and before Dec. 17, 2010, if the estate timely files Form 4768 and then files Form 706 or Form 706-NA and pays the estate tax by Mar. 19, 2012, or (2) died after Dec. 16, 2010 and before Jan. 1, 2011, if the estate timely files Form 4768 and then files Form 706 or Form 706-NA and pays the estate tax within 15 months (i.e., nine months under **Code §6075(a)**, plus the new *automatic* six-month extension) after the decedent's date of death.

New Due Date and Penalty Relief for Filing Form 8939: The due date for filing Form 8939 is also being changed from Nov. 15, 2011 to Jan. 17, 2012. As a result, a Code §1022 election will still be considered as being "timely filed" if the Form 8939 is filed by (and, it can be amended or revoked prior to) that 1/17/2012 date. However, no further extensions will be granted to file Form 8939, or to make, amend, or revoke the Code §1022 election, except as provided in **Notice 2011-66** (i.e., under which an executor may file an amended Form 8939, if the provisions of **Reg. §301.9100-2(b)** are met for an automatic six-month extention, by July 17, 2012). Furthermore, the penalty under **Code §6716** does *not* apply to the executor of a 2010 estate because: (i) the Form 8939 is filed after Nov. 15, 2011, but on or before Jan. 17, 2012; or (ii) a statement required to be furnished to beneficiaries is provided after Dec. 15, 2011 but on or before Feb. 17, 2012.

Generation-Skipping Transfer (GST) Relief: If an executor makes a Code §1022 election on a Form 8939 filed on or before Jan. 17, 2012, and allocates the decedent's available GST exemption on an attached Schedule R or R-1, the allocation or election will be considered timely and effective as of the decedent's date of death under **Code §2632**. On the other hand, **Code §2632's** "automatic allocation" rules will apply if the executor timely files the Form 8939 without attaching a Schedule R or R-1. However, if the executor does *not* make (or, timely revokes) the Code

§1022 election, then the "automatic allocation" rules will apply unless the executor timely files Form 706 or Form 706-NA with the Schedule R or R-1 attached.

Income Tax Return Penalty Relief: The IRS felt that a recipient of property inherited from a 2010 decedent who disposed of such property during 2010 "may *not* know relevant information, such as whether any amount of basis increase will be allocated to the property, at the time that the recipient filed or files his income tax return." As a result, when filing the recipient's income tax return and computing the income tax liability, "the recipient will have to make a good faith estimate." Therefore, **Notice 2011-76** provides that, to the extent that the recipient's tax liability is increased (as shown on an amended return or otherwise) by reason of a Code §1022 election, the IRS will presume that the recipient "acted with reasonable cause and good faith" and therefore will *not* impose either the **Code §6651(a)(2)** or **Code §6662(a)** penalties. However, the recipient should write **"IR Notice 2011-76"** across the top of the amended return.

Comment: Notice 2011-76 specifically states, however, that its relief provisions do *not* extend to: (i) the due date for paying any income tax or for filing any income tax return for any individual, estate, or trust; (ii) the due date for paying any gift tax or for filing any Form 709; or (iii) the time to file an estate or inheritance tax return required by any state or to pay any estate or inheritance tax due to such state.

Effective Date: Notice 2011-76 is effective Sept. 13, 2011, and applies to each executor of a 2010 estate and to persons acquiring property from a 2010 decedent. **(Code §2031; Estate Tax)**

☞Safe Harbor Basis Rules Available for Zero Estate Tax Election for 2010 Decedents (Rev. Proc. 2011-41)

As mentioned in **Notice 2011-66**, the IRS has issued long-awaited detailed guidance on how estates of decedents who died in 2010 can choose zero estate tax at the price of beneficiaries being limited to the decedents' basis (plus certain increases due to the modified carryover basis rules) under **Code §1022**. In this revenue procedure released simultaneously with the notice, the IRS has provided "safe harbor basis rules" for purposes of the election.

Background: As discussed in **Notice 2011-66**, §301(c) of the 2010 Tax Relief Act allows estates of decedents dying in 2010 to choose to *not* have the estate tax rules apply. However, if the election is made, beneficiaries are limited to the carryover basis rules under **Code §1022**.

Carryover Basis Rules: Code §1022 applies to the estate of a decedent who died in 2010 only if the executor makes the Section 1022 Election. **Code §1022(a)(1)** generally provides that property acquired from the decedent (within the meaning of **Code §1022(e)**) is treated "as having been transferred by gift." If the decedent's basis is *less than or equal to* the property's fair market value determined as of the decedent's date of death, the decedent's basis carries over to the beneficiary. (**Code §1022(a)(2)(A)**) On the other hand, if the decedent's basis is *greater* than that FMV, the recipient's basis is limited to that FMV. (**Code §1022(a)(2)(B)**)

If the executor of the estate of a decedent who died in 2010 does make the Section 1022 Election, **Code §1022** applies to determine a recipient's basis in *all* property acquired from that decedent, regardless of the year in which the property is sold or distributed. (**Rev. Proc. 2011-41, §4.01(1)**)

Modified Step-Up in Basis Rules: Code §1022(b) and **Code §1022(c)** allow the executor to allocate additional basis (i.e., $1.5 million to all nonspousal beneficiaries, plus an additional $3 million to surviving spouses) to increase the basis of certain assets that both are acquired from the decedent and are deemed as still being owned by the decedent at death (within the meaning of **Code §1022(d)**). If the decedent's basis in the property is *less* than the property's FMV on the decedent's date of death, then the executor generally may allocate any basis increase to the property, provided that the property's total basis (i.e., after the allocation) does *not* exceed the property's FMV as of the date of death.

Comment: Take special care to note that any step-up allowed under the modified carryover basis rules cannot serve to increase the decedent's basis at death above what the FMV is as of the date of death. And, if the adjusted basis of the property held by the decedent at death is already more than its FMV, then none of the $1.3 million step-up (i.e., for nonspousal beneficiaries), plus the $3 million additional step-up (i.e., for surviving spouses) can be used to increase this AB over FMV gap even more.

Property Not Subject to Code §1022: If the election is made, **Code §1022** will apply to determine a recipient's basis only in property acquired from the decedent. As clarified in **Rev. Proc. 2011-41, §4.01(2)**, **Code §1022** does *not* determine the recipient's basis in every type of property transferred from a decedent who died in 2010.

Property Acquired From Decedent: Property acquired from the decedent (within the meaning of **Code §1022(e)**) is property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent. It also includes certain property transferred by the decedent during the decedent's lifetime, as detailed in **Rev. Proc. 2011-41, §4.01(3)**. However, it does *not* include a decedent's interest in a QTIP trust.

Property Owned By Decedent: Property acquired from the decedent must also be owned by the decedent at death (within the meaning of **Code §1022(d)**) to be eligible for the allocation of any basis increase under **Code §1022(b)** and/or **Code §1022(c)**.

(**Code §1022(d)(1)(A)**) Specifically, **Rev. Proc. 2011-41, §4.01(4)** provides detailed statutory rules which define "ownership" for this purpose. For example, property over which the decedent holds any power of appointment (i.e., under **Code §2041**) is *not* considered "owned by the decedent at death" (i.e., even though it would normally have to be included in the decedent's gross estate).

Property Not Eligible Basis Increase: Any basis increase may *not* be allocated to the following property:

- Under **Code §1022(d)(1)(C)**, the executor is *not* permitted to allocate an basis increase to property that is acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the *three-year period* ending on the date of the decedent's death. However, this restriction does *not* apply to property acquired by the decedent from the decedent's spouse, provided the property had *not* been transferred to the spouse during such three-year period in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth.

Calculating the Basis Increase: The "basis increase" consists of the sum of the "general basis increase" (i.e., "aggregate basis increase" plus any carryovers or unrealized losses increase as shown on Lines 10-12 on Form 8939) under **Code §1022(b)** and the "spousal property basis" increase under **Code §1022(c)**. The "aggregate basis increase" is $1,300,000 under **Code §1022(b)(2)(B)**. The "carryovers or unrealized losses increase" consists of the sum of: (i) the amount of any capital loss carryovers under **Code §1212(b)** that would (but for the decedent's death) have been carried from the decedent's last tax year to a later tax year; (ii) the amount of any net operating loss carryovers under **Code §172** that would (but for the decedent's death) have been carried from the decedent's last tax year to a later tax year; and (iii) the amount of unrealized losses that would have been allowable under **Code §165** if the property acquired from the decedent had been sold at FMV immediately before the decedent's death. (**Code §1022(b)(2)(C)**) However, losses described in **Code §165(c)(3)** may *not* be included in the "carryovers or unrealized losses increase." And, for the purpose of computing "unrealized losses," the capital loss limitations referred to in **Code §165(f)** are ignored (i.e., capital losses limited to capital gains on an annual basis, plus $3,000). (**Code §1022(b)(2)(C)(ii)**)

In determining the decedent's share of these loss carryovers and unrealized losses, existing income tax rules apply, if the decedent's final Form 1040 is filed jointly with the decedent's surviving spouse. (**Rev. Proc. 2011-41, §4.02**)

Comment: In other words, there would be one last chance to use these tax attributes against the joint taxable income of the couple, given the normal income tax rules otherwise allowed this approach. For instance, supposed the decedent maintained a stock portfolio in his name only and had incurred significant capital losses previously, resulting in a carryover. On his final joint return, this LTCL carryover could only be used to the extent of the decedent's capital gains, plus $3,000 (i.e., and *not* against capital gains on investments held solely in his wife's name). Or, suppose the decedent had a significant NOL carryover from his Schedule C or F business during his lifetime. This NOL would only be available against his ordinary income sources and *not* those of his wife's.

Comment: Another advantage of these unused tax attributes, for instance, is that the amount of the decedent's unused NOL and capital loss carryovers can be added to the basis-step-up ceilings of $1.3 million and $3 million. And, if the decedent has assets that are worth less than their basis, the shortfall is added, too. If basis is allocated to depreciable assets, the heir treats the added basis as belonging to a new asset which is treated as being placed in service as of the decedent's death. But, remember if an estate satisfies any cash bequests with appreciated assets, it will owe tax on the gain.

Comment: This ability to utilized a decedent's tax attributes that still existed after his final Form 1040 income tax return is filed is huge. They can serve to increase either the $1.3 million step-up for nonspousal beneficiaries or the $3 million step-up for surviving spouses. In 2011, when the modified carryover basis rules are no longer available, then such attributes of the decedent that were *not* used up on his final income tax return would "go to the grave" with him and be wasted.

Spousal Property Basis Increase: The "spousal property basis increase" is $3,000,000 under **Code §1022(c)(2)** and may be allocated to any or all property owned by and acquired from the decedent that also satisfies the definition of "qualified spousal property" in **Code §1022(c)(3)**. Qualified spousal property is property that either is transferred outright to the decedent's surviving spouse or is QTIP (i.e., as defined in **Code §1022(c)(5)**), whether or not held in trust. However, the definition of QTIP under this provision does *not* require that a QTIP election under **Code §2056(b)(7)** be made. The executor is free to allocate this spousal property basis increase to qualified spousal property that has already been distributed. In addition, if certain conditions are met, the spousal property basis increase may also be allocated to property that is sold (regardless of whether the allocation of spousal property basis increase is made before or after the sale) prior to its distribution.

Comment: The allocation of spousal property basis increase to property *not* distributed in-kind is illustrated in examples in **Rev. Proc. 2011-41.**

General Rules for Allocating Basis Increase: The executor may allocate the basis Increase to property owned by and acquired from the decedent on a property-by-property basis, provided that the decedent's adjusted basis in each such property (after the allocation, if any) does *not* exceed the FMV of that property as of the date of the decedent's death. For example, the basis increase may be allocated to one or more shares of stock or to a particular block of stock rather than to the decedent's entire holding of that stock. Generally, basis increase may be allocated to property owned by and acquired from the decedent even after the executor has disposed of or distributed the property. (**Rev. Proc. 2011-41, §4.03**)

Determination of FMV: The FMV of property acquired from the decedent who died in 2010 is determined in the same manner for purposes of **Code §1022** as for purposes of the estate tax. As a result, regs requiring appraisals to determine the FMV of certain property included in the gross estate also apply for purposes of determining the FMV of property acquired from the decedent under **Code §1022** . And, the executor must attach any such appraisals to the Form 8939. (**Rev. Proc. 2011-41, §4.04**)

Community Property: Rev. Proc. 2011-41, §4.05 provides special rules for community property, which are illustrated in detailed examples.

Interaction With Other Income Tax Provisions: Rev. Proc. 2011-41, §4.06 explains how **Code §1022** interacts with other income tax provisions including: (1) the holding period of inherited property, (2) the tax character of inherited property, (3) depreciation of property acquired from the decedent, (4) the passive activity loss provisions, and (5) recognition of gain on satisfaction of pecuniary bequest with appreciated property.

Effective Date: Rev. Proc. 2011-41 is effective Aug. 29, 2011 (i.e., the date of publication in the Internal Revenue Bulletin). However, the Service has stated that taxpayers are permitted to apply it for prior periods, if they so choose. **(Misc.; Modified Carryover Basis Rules)**

IRS Properly Refused to Abate Interest on Estate's Income Taxes (*Estate of Nicolas Telesmanich*, TC Memo 2011-181 (8/1/2011))

The IRS properly turned aside a request to abate interest on an estate's Form 1041 income tax liabilities. This was in spite of the fact that an IRS employee assured the executor that "nothing would be owed except the taxes" when the executor informed the IRS employee that he did *not* have the funds to pay the taxes until he finally got access to the estate's funds. The Tax Court agreed that the employee's statement was *not* to be interpreted as a "ministerial act justifying abatement under **Code §6404**." Therefore, it was *not* sufficient to invoke the doctrine of equitable estoppel.

Background on Interest Abatement: The IRS is permitted to abate the assessment of interest on any payment of tax to the extent that "any unreasonable error or delay in such payment is attributable to an IRS officer or employee being erroneous or dilatory in performing a ministerial or managerial act." Furthermore, the IRS may abate the assessment of interest "only when no significant aspect of the error or delay is attributable to the taxpayer." (**Code §6404(e)(1)**) A "ministerial act" is a "procedural or mechanical act that does *not* involve the exercise of judgment or discretion and occurs during the processing of a taxpayer's case after all the prerequisites to the act, such as conferences and review by supervisors, have taken place." (**Reg. §301.6404-2(b)(2)**) Conversely, a decision or advice rendered "concerning the proper application of Federal tax law is *not* a 'ministerial act'." (**Reg. §301.6404-2(b)**)

Code §6404(h) allows taxpayers to challenge denials of interest abatement in the Tax Court. However, on this particular issue, the Supreme Court, in ***Hinck v. U.S.*, 99 AFTR 2d 2007-2814 (S Ct, 5/21/2007)**, held that "the Tax Court's jurisdiction is exclusive."

Facts: On Sept. 14, 2000, Nicholas Telesmanich who was a U.S. citizen died. His nephew Kresimir Telesmanich was named executor of the estate. The estate included $438,572 held in accounts with Fidelity Investments. At the time of his death, Nicolas resided in Croatia. Kresimir attempted to have his uncle's will probated in New Jersey, but the New Jersey court required that the will be probated in Croatia. But, the Croatian court refused to issue letters testamentary or to recognize the executor, and Nicolas was unable to gain access to the estate's funds until February of 2008 (i.e., over 7 years after the date of his uncle's death).

In 2002, Kresimir contacted the IRS to obtain an employer identification number for the estate. Shortly thereafter, he received a letter from the IRS stating that he was required to file a Form 1041 for 2001. Kresimir called the IRS and explained that he was unable to pay the taxes because he was unable to gain access to the estate's funds. He was unable to name the person with whom he spoke or the exact date on which the call took place. Nevertheless, this unidentified IRS employee instructed him "to pay the taxes when he gained access to the funds and to send a letter to the IRS explaining his situation," which Kresimir promptly did. The IRS employee told him that he "would *not* owe anything other than the taxes." After that conversation, Kresimir was under the impression that interest would *not* accrue on the underlying tax liabilities, although the IRS employee did *not* specifically mention whether interest would be assessed. Once Kresimir finally gained access to the estate's funds in 2008, he promptly filed the estate's Forms 1041 for years 2001 through 2006 and paid the corresponding tax liabilities. Upon receipt of the returns, the IRS still assessed late-filing and failure-to-pay additions to tax, along with interest on the additions to tax and underlying tax liabilities. Subsequently, the IRS abated the additions to tax and interest thereon at Kresimir's request, but *not* the interest on the underlying tax liabilities. It subsequently issued a final determination letter denying the estate's claim for abatement of $2,816 in

interest on tax liabilities for 2001, 2002, and 2004 through 2006. Kresimir then asked the Tax Court to review the Service's denial of the interest abatement request for this year. Kresimir contended that the estate should be entitled to interest abatement because the IRS employee with whom he spoke specifically told him no additional payments would be required "if he paid the taxes when the funds became available." Meanwhile, the IRS countered that this could *not* be grounds for abatement because it involved "the proper application of Federal tax law and thus was *not* a ministerial act."

Tax Court Decision: The Tax Court agreed that "any incorrect advice as to whether the estate would be assessed interest would constitute advice on the proper application of Federal tax law and *not* a ministerial act." Furthermore, Kresimir did *not* show that the IRS employee's error caused him to delay the payment of taxes. Even if the IRS employee had told him about the accrual of interest, "there was nothing to suggest that the taxes would have been paid any earlier than when the funds became available." As a result, the IRS was *not* responsible for the delay in payment, "with or without any alleged error by the IRS employee." **(Code §6404; Interest Abatements)**

Precise Wording Should Be Used When Drafting HEMS Standard (*Estate of Chancellor*, TC Memo. 2011-172 (7/14/2011))

When drafting a will or trust document, failing to use precise wording can result in challenges from the IRS and other unintended tax consequences. Here, a trust document was drawn up which granted the surviving spouse the power to withdraw assets in order to meet her needs for "necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures." But, under **Code §2041**, if a beneficiary can extract assets from a trust (i.e., because of a general power of appointment), the FMV of *all* of the assets remaining in the trust would have to be included as part of the beneficiary's estate at death. However, the assets do *not* have to be added to the estate when the withdrawal power is limited to amounts needed for the person's "health, education, maintenance or support" (i.e., an "ascertainable standard" known as the HEMS standard). However, when the language is vague, as it was in this case, the Service might insist that the standard is "too broad" resulting in all of the trust's assets being included in her gross estate. Although it involved going through an IRS audit, then appeals, and finally, being contested in Tax Court, the estate was able to convince the court that the wording of the trust should *not* cause such a result. **(Code §2041; Powers of Appointment)**

> **Comment:** It's a shame that all of these costs had to be incurred where, if a knowledgeable professional had been used to draft the document, it could have all been avoided.

RETIREMENT PLANS & FRINGE BENEFITS:

SIFL Rates Increase in Second Half of 2011

The Standard Industry Fare Level (SIFL) formula may be used in certain instances to determine the value of a noncommercial flight for employment tax purposes. The Dept. of Transportation has **announced** that the SIFL rates for the second half of 2011 (i.e., July 1 through December 31) have been issued. The terminal charge has increased to $41.53 (previously, $40.90). The rate for the first 500 miles of travel is now 22.72¢ per mile (previously, 22.37¢ per mile). The rate for miles 501 to 1,500 is now 17.32¢ per mile (previously, 17.06¢ per mile). The rate for miles traveled over 1,500 is now 16.65¢ per mile (previously, 16.40¢ per mile). **(Code §62; SIFL Rates)**

Disability Exception Inapplicable to Early Retirement Distribution (*Simeon Isaacs*, TC Memo 2011-175 (7/25/2011))

A taxpayer was subject to the 10% early withdrawal penalty after finding that he did *not* meet the technical requirements of the "disability exception" under **Code §72(m)(7)** for a "mental illness or disease." The taxpayer testified to a psychological evaluation confirming his condition, as well as an attempted suicide and hospitalization. Nevertheless, the Tax Court focused on the fact that he "did *not* require institutionalization or constant supervision," and he "continued to engage in substantial gainful activity through various business ventures." **(Code §72(t); Early Withdrawal Penalty)**

☞10th Circuit Overturns Tax Court - Farmer Allowed to Deduct Medical Reimbursements Paid to Working Spouse (*Shellito*, 108 AFTR 2d ¶2011-5218 (10th Cir., 8/24/2011))

The 10th Circuit has *reversed* the Tax Court's decision which held that a farmer should *not* be permitted to deduct on Schedule F medical reimbursements paid to his spouse whom he claimed was an employee of the farming business. Specifically, it remanded the case back to the Tax Court for the simple determination of whether or not the spouse was a bona fide employee by applying the common law doctrine.

> **Comment:** Companies such as Total Administrative Services Corporation (TASC - see **www.tasconline.com**) administer programs like ***AgPlan*** and ***BizPlan*** whereby the proprietor's spouse can be hired as a full-time employee and given complete family coverage, along with other common fringe benefits on a pre-tax basis (i.e., something that the proprietor could *not* have arranged for himself except for the amounts paid for health insurance premiums).

Background: The owner of an unincorporated business is permitted to deduct under **Code §162(a)** the ordinary and necessary expenses he pays or incurs during the tax year in carrying on a trade or business, including amounts reimbursed to an employee under an employee benefit plan for an expense that such employee pays or incurs. (**Reg. §1.162-10(a)**) However, the owner of an unincorporated business is *not* permitted to deduct health insurance costs that he pays or incurs for himself, his spouse, and his

dependents except as provided in **Code §162(l)**.

For tax years beginning in '99 through 2001, a self-employed taxpayer was allowed to deduct 60% of his health insurance premiums as an above-the-line deduction under **Code §162(l)**. The deductible percentage was 70% for tax years beginning in 2002. Under current law, a self-employed individual's health insurance premiums (including those for his spouse, dependents, and children under age 27) are 100% deductible. However, the deduction is available only to individuals who are *not* eligible to participate in a subsidized health plan maintained by an employer of the individual, his spouse, or any child under age 27. Where the spouse is an employee, the employer can deduct health insurance expenses under **Code §162(a)** rather than **Code §162(l)**. In **Rev. Rul. 71-588**, the IRS stated that amounts paid under a self-insured accident and health plan by a sole proprietor to his employee-spouse for the medical costs of her spouse (i.e., the sole proprietor) were deductible ordinary and necessary business expenses.

Facts: Mr. Shellito was engaged in a farming business in Kansas since about '78. In 2001 and 2002 (the years at issue here), his farming operation covered about 2,300 acres. Mrs. Shellito assisted on the farm since at least '82. The nature of her services remained fairly constant over time. Before, during, and after the years at issue, her services included: assisting with the planting and harvesting of crops; operating tractors and equipment; feeding and caring for cattle; building and repairing fencing; maintaining and performing basic equipment repairs; running various errands; and performing accounting and bookkeeping services. But, prior to 2001, Mrs. Shellito received no compensation for these services. In 2001, a CPA advised Mr. Shellito that he could qualify for an employee medical reimbursement plan if Mrs. Shellito were his bona fide employee. They went along with his advice and bought a commercially marketed package for family farmers. The Shellitos signed a brief employment agreement prepared by their accountant, dated May 29, 2001. It declared that Mr. Shellito was employing his wife as a hired hand to do farm work he directed her to do; but it did not specify either hours or compensation. Mrs. Shellito opened an individual checking account which she used to pay the family's (including her employer-husband's) medical bills not covered by insurance. She also paid the insurance premiums on her policy (i.e., instead of having the business pay them, although she was reimbursed, but it was out of the family's account v. the business' account). Mr. Shellito paid her $100 per month as wages and also reimbursed her for the payment of medical bills and expenses out of her personal checking account. He made these payments to her using checks signed by him, on their joint checking account, for deposit into her individual account. Mrs. Shellito kept a daily log of her hours spent in farm work, although *not* specifying what work was done. Mrs. Shellito was the only eligible employee of Mr. Shellito. For 2001 and 2002, on Schedule F, Mr. Shellito deducted wages and medical reimbursements provided to Mrs. Shellito. It was odd, though, that she still listed her occupation on their Forms 1040 for those years as a "housewife." The IRS disallowed the reimbursements but did allow a deduction for self-employed health insurance premiums (that Mr. Shellito would have otherwise been allowed even if his wife was *not* an employee).

Tax Court Decision: The Tax Court agreed with the IRS that Mrs. Shellito was *not* her husband's bona fide employee because she was *not* compensated. She got no economic benefit from funds paid into her individual account from the couple's joint checking account because she was presumed to already be an equal owner in the funds in that account. The Tax Court also found that her payment of medical expenses from her individual checking account "was simply an assumption of her husband's liability under state law for the family's medical expenses." It concluded that "the form of the transactions in question did *not* reflect their substance and did *not* give rise to a true employment relationship." As additional support for its conclusion, the Tax Court pointed to the fact that Mrs. Shellito had done the same farm work for nineteen years without compensation. It also did *not* help that she continued to list her occupation on the Form 1040 as a "housewife" even after this employment arrangement was entered into.

> **Comment:** The curious thing is that, if they are in fact using a commercially available arrangement such as ***AgPlan***, they would have been directed to have the insurance in the name of the business. Or, at the very least, have the business pay the premiums, as well as making the reimbursements to this spousal employee. That would have been a much cleaner approach and probably would have avoided the Tax Court's disapproval.

Appeals Court Decision: The 10th Circuit *reversed* the Tax Court's decision, stating that it "erroneously relied on the doctrine of necessaries under Kansas law, which applies equally to husbands and wives and imposes upon each a duty to provide for the other's necessities, including medical services." However, that duty "only comes into force to the extent that one of the spouses is unable to provide for themselves." In addition, the 10th Circuit had trouble understanding why the IRS "would even attempt to advance the argument that Mrs. Shellito's payments should be disregarded because they convert a legal support obligation into a deductible expense." The Court pointed out that this position has *not* been adopted by the IRS "since it would punish a taxpayer for employing a spouse or family member." Under **Rev. Rul. 59-110**, for wages paid to a child for services actually performed, the fact that there "may [also] be a legal obligation to support the child is *not* determinative of the deductibility of the wages as a business expense." And, the Appeals Court felt that "the same reasoning applies to a spouse." It also concluded that "the proposition that the deductibility of medical reimbursement payments depends on whether or not medical expenses might be paid from another source, even if that source has an obligation to pay, is also *not* supported by any case law, and would result in

inconsistent treatment of benefit plans and a disincentive to employers to provide benefits."

In reaching its decision, the10th Circuit also rejected the Tax Court's disqualification of any amounts received by Mrs. Shellito as compensation because they originated from the couple's joint checking account. If the use of a single joint account should disqualify spousal employment arrangement, then in the eyes of the Court, why is this "threshold bar" *not* also used in any of the decided cases dealing with the same issue as in the Shellito's case. In fact, it was *not* even mentioned in **Rev. Rul. 71-588**. The Court also took note of the fact that "a separate account requirement would simply invite another structural layer." For example, in the Shellitos' case, it would require that the farming business have a separate account, from which funds would simply be transferred to the general joint account and/or to Mrs. Shellito's separate account. But, this would also be somewhat irrational, since the business account would probably be in joint tenancy anyway (i.e., because the business relied on Mrs. Shellito to do the bookkeeping). Furthermore, the Court did *not* feel that Mrs. Shellito "had received any economic benefit because her financial position with a separate account was the same as without it ignored the reality of spousal employment." For instance, the couple's combined gross income would obviously *not* change even if they had instituted the changes that the Tax Court had recommended. The bottom line is that "employment of a spouse in a small business is done to avoid decreasing the couple's income, which would result from paying an unrelated hired hand." The 10th Circuit therefore remanded the case to the Tax Court for further consideration, instructing that it begin its analysis of whether or not Mrs. Shellito was a bona fide employee by applying the common law doctrine. **(Code §162; Spousal Employment)**

EMPLOYMENT TAXES:

☞IRS Offers Warning for Employers Outsourcing Payroll (IRS e-News for Small Businesses, Issue No. 2011-17)

The IRS continues to issue stern reminders to all employers that they are ultimately responsible for the payment of any income or payroll taxes withheld, even if they outsource their payroll responsibilities to a third party. While there is no question that outsourcing payroll to a third party "can help ensure that filing deadlines and deposit requirements are met and greatly streamline business operations," it is still the employer's ultimate responsibility to pay these taxes, even if the failure to pay is entirely due to the payroll service provider's negligence or fraud.

IRS Recommendations: Regarding this issue, the IRS continues to offer the following guidelines to employers considering such arrangements:

- It strongly suggests that the address of record with the IRS *not* be changed to that of the payroll service provider so that if there are any issues with an account, the IRS will be able to contact the employer directly. If, instead, the employer allows the address of the payroll service to be used for correspondence with the IRS, it "may significantly limit the employer's ability to be timely informed of tax matters involving its business."

- It advises employers to make sure that the payroll service provider is using the Electronic Federal Tax Payment System (EFTPS). EFTPS maintains a business's payment history for 16 months and can be viewed on-line. That way, an employer "can immediately confirm payments electronically, 24 hours a day, 7 days a week, through the Internet or by phone." Employers should register on the EFTPS system to get their own PIN and use this PIN to periodically verify payments. Most importantly, "a red flag should go up the first time a payroll service provider misses or makes a late payment." Employers with an EFTPS account will also be able to make additional tax payments that their payroll service provider is *not* making on their behalf (e.g., estimated tax payments). **(Code §3401; Payroll Services)**

> **Comment:** There have already been several **instances** of individuals and companies posing as payroll service providers who have instead stolen funds intended for payment of employment taxes. Therefore, the Service recommends that any employer who believes that a bill or notice received is a result of a problem with their payroll service provider should contact them as soon as possible by calling the number on the bill, writing to the IRS office that sent the bill, calling (800) 829-4933, or visiting a local IRS office.

Service to Discontinue Attributed Tip Income Program (IRS Headliner 314, 8/8/2011)

The IRS has announced that it is discontinuing the Attributed Tip Income Program (ATIP), effective Dec. 31, 2011. ATIP is a voluntary tip reporting pilot program that began in 2007. The objective of the program was "to simplify the recordkeeping burden for reporting tip income in the food and beverage industry." The Service has decided to discontinue the program "because it attracted only a small number of participants." Employers who elected to participate in ATIP for the 2011 calendar year, along with their participating employees, may still use the program through the end of the year. Beginning in 2012, the IRS has suggested that employers may want to consider other voluntary tip reporting **programs**, such as the Tip Reporting Determination Agreement or the Tip Reporting Alternative Commitment, if they are interested in continuing in a voluntary tip reporting program. **(Code §3401; ATIP)**

ADMINISTRATIVE & PROCEDURAL MATTERS:

85 Years of JCT Documents Now Available on Website

The Joint Committee on Taxation (JCT) has posted on its **website** copies of most known JCT publications from 1926, when the committee was created, through

the present. "The postings provide congressional offices and the general public with a more complete and searchable set of documents relevant to the evolution of the Internal Revenue Code, than the Joint Committee previously had made available on its website," JCT said in a statement. **(Misc.; JCT)**

> **Comment:** It cannot be overstated as to the importance of the JCT Committee Reports (i.e., the "Blue Books") when it comes to discerning the "legislative intent" behind a particular law that Congress has passed. And, now, all of this vital information can be found on their website.

Updated Version of Circular 230 Released

An updated version of Circular 230 (revised 8/11) has been posted to the IRS website. The 8/11 revision incorporates changes to the rules of practice issued on 6/6/11, which mainly addressed the new "registered tax return preparer" designation. However, some provisions affect all practitioners. For example, under revised Section 10.34(a), practitioners cannot sign a tax return or claim for refund with a position (or advise a client to take a position) that: (1) lacks a reasonable basis; (2) is an unreasonable position under **Code §6694(a)(2)** ; or (3) is due to willful or reckless conduct under **Code §6694(b)(2)**. Revised Section 10.36(b) requires management with principal authority and responsibility for overseeing a firm's tax return practice to take reasonable steps to ensure there are adequate procedures in place for complying with Circular 230. **(Misc.; Circular 230)**

IRS Exams & Enforcement Increasing (Audit Report No. 2011-30-071)

Fiscal Year (FY) 2010 collection activities showed mixed results when compared to FY 2009, according to this recent TIGTA report. It did note that the IRS "continued to increase the use of collection enforcement tools." Also, the number of delinquent accounts closed by full payment increased, as did the amount collected on delinquent accounts. However, the Collection function received more delinquent accounts than it closed, gross accounts receivable increased, and the number of tax delinquency investigation tax periods closed with the receipt of a delinquent tax return decreased. In addition, while the number of taxpayers with delinquent accounts and delinquent returns in the Queue decreased, it was offset by an increase in the number of these cases that were shelved or surveyed. TIGTA also noted that the number of tax returns examined increased for individual, corporate, and S corporation tax returns in Fiscal Year (FY) 2010, while the number of partnership examinations decreased and examinations of other types of tax returns remained the same. The report attributed this to an increased number of revenue agents and tax compliance officers, which resulted in "the most tax returns examined over the past five years, although the majority of these examinations were conducted via correspondence." Nevertheless, the no-change rates for examinations of individual income tax returns by revenue agents and tax compliance officers increased in FY 2010, but was lower than the no-change rates reported in FY 2006. **(Misc.; IRS Audits)**

IRS Fails to Properly Respond to Taxpayer Correspondence (Audit Report No. 2011-40-058)

The conclusion reached in this recent TIGTA audit was that the IRS "does *not* adhere to its self-imposed policy of providing quality and timely responses to taxpayers' correspondence regarding tax issues." As summarized in the audit report, the agency's policy, which is contained in Policy Statement P-6-12, is to respond to a taxpayer within 30 calendar days, or at least provide an update on the status of the response. The audit found that while most responses to tax issue inquiries were accurate, the timeliness of most responses was inadequate. Interim letters are often mailed when the 30-day deadline cannot be met, the audit noted. "However, none of the systemically issued interim letters provide taxpayers with any information specific to their accounts, and the content is not clear regarding what taxpayers need to do," TIGTA said. The results of the audit were based on two statistical samples and one judgmental sample from three IRS functions. According to the audit, of 73 correspondence cases sampled from the Accounts Management function, just 14 taxpayers (or 19%) received timely and accurate responses. In the review of 48 correspondence cases sampled in the Automated Underreporter Program, every taxpayer received an accurate response, but only 27 (or 56%) received a timely response. In the third sample of 73 correspondence cases from the Field Assistance Office, just six taxpayers (or 8%) received timely and accurate responses. Auditors also found that required interim letters were *not* always issued. "Finally, the IRS is *not* following Policy Statement P-6-12 guidelines and has *not* implemented any measures or processes to monitor and evaluate Policy Statement P-6-12 correspondence to ensure taxpayers receive timely responses to their correspondence," TIGTA said. **(Misc.; IRS Correspondence)**

IRS Provides High Level of Accuracy in Response to Tax Law Questions (Audit Report No. 2011-40-070)

Based on the results of this recent TIGTA audit, taxpayers receive "helpful and accurate" tax law assistance from the IRS, but they often encounter "lengthy" delays before they are able to speak with assistors. TIGTA found particular difficulties at Taxpayers Assistance Centers (TACs). The audit was a follow-up to a previous audit on the subject. In this instance, auditors posed as taxpayers once again, seeking to obtain answers to tax law questions, assess the ease of obtaining answers and the accuracy of the answers provided, and assess the quality of services received from a taxpayer's point of view. They submitted questions through IRS's toll-free telephone assistance lines, website, and TACs. "Auditors received accurate responses to all tax law questions, and were able to accurately prepare tax returns using the various IRS sources, including the Free File Program," TIGTA said. On the plus side for TACs, contact recordings of tax return preparation assistance provided at TAC locations nationwide showed that assistors accurately prepared tax returns, the audit

noted. However, wait times at the TACs, as well as on the telephones, "were excessive." At TACs, auditors were required to wait an average of one hour. There were also documented instances of auditors being denied service and told to return on another day. "In addition, TACs do *not* always allow qualified taxpayers to schedule appointments and do *not* consistently apply new taxpayer screening guidelines and procedures," the audit said. "An important part of the IRS's mission is to help taxpayers understand and meet their tax obligations," said J. Russell George, the inspector general. "We urge the IRS to make improvements as we have outlined in order to improve taxpayer service." **(Misc.; IRS Tax Assistance)**

Federal Budget Deficit Surpasses $1.1 Trillion (CBO Monthly Budget Review)

The federal budget deficit for the first ten months of fiscal year 2011 was $1.1 trillion, which was $66 billion *below* the deficit recorded over the same period in FY 2010, according to the latest estimate by the Congressional Budget Office. During the 10-month period, revenues were up by $141 billion (or 8%) compared to 2010, but outlays also increased by $75 billion (or 3%). Individual income tax receipts grew by $172 billion (or 23.8%) for a year-to-date total of $891 billion. CBO described this as a "significant increase." Withheld income and payroll taxes rose by $53 billion (or 4%). Non-withheld income and payroll taxes increased by $47 billion (or 17%). "The gains in withheld and non-withheld individual taxes alike can be attributed, at least in part, to increases in the underlying tax bases (wages and nonwage income)," CBO said. There was a decline of about $9 billion in estate and gift taxes, "stemming from the temporary repeal of the estate tax for calendar year 2010," CBO noted. Receipts in July were $4 billion (or 2%) higher than in July 2010, primarily due to a decline in refunds of individual income taxes. "In addition, receipts from withheld income and payroll taxes were $1 billion higher, as were receipts from non-withheld taxes, reflecting an increase in people's incomes," CBO said. Corporate income tax receipts were $1 billion less than in the previous July. Spending for net interest on the public debt rose by $5 billion and outlays for Social Security benefits grew by $2 billion. Outlays for Medicaid fell by $5 billion and payments for unemployment benefits declined by $3 billion. **(Misc.; Budget Deficit)**

Service Issues Per Diem Rates for FY 2012 (GSA Per Diem Bulletin FTR 12-01)

The General Services Administration has posted the federal domestic per diem rate table for fiscal year 2012 on its website. The rates are in effect from Oct. 1, 2011 through Sept. 30, 2012.

Background: The per diem rate table is used by employers who pay a per diem allowance to employees for business travel away from home within the continental United States (CONUS). The per diem allowance is an alternative to reimbursing employees for their actual substantiated expenses for away-from-home lodging, and meals and incidental expenses (M&IE). However, the per diem rate may *not* exceed the rate paid by the federal government to its workers on travel status. And, the rate varies by locality of travel. But, if employees provide simplified substantiation (i.e., time, place, and business purpose), the per diem reimbursement is *not* subject to income or payroll tax withholding and is, therefore, *not* reported on the employee's Form W-2.

2012 FY Per Diem Rates: Total per diem rates by locality for fiscal year 2012 will range from $123 to $367. Vail, Colorado has the highest per diem rate in the table (i.e., $367 during the period from Dec. 1, 2011 to March 31, 2012). Furthermore, the following localities have been added to the table for fiscal year 2012:

- Montgomery (Montgomery and Autauga Counties), Alabama;
- Ocala (Marion County), Florida;
- Michigan City (LaPorte County), Indiana;
- Alexandria/Leesville/Natchitoches (Allen, Jefferson Davis, Natchitoches, Rapides, and Vernon Parishes), Louisiana;
- Benton Harbor (Berrien County), Michigan;
- Mackinac Island (Mackinac County), Michigan;
- Mount Pleasant (Isabella County), Michigan;
- Jefferson City (Cole County), Missouri; and
- Sheboygan (Sheboygan County), Wisconsin.

Comment: The maximum standard per diem rate for travel locations *not* listed in the per diem rate table has *not* changed and will remain at $123 ($77 for lodging, $46 for M&IE) in fiscal year 2012.

Meals & Incidental Expenses: Finally, there are six possible M&IE rates. These rates (i.e., $46, $51, $56, $61, $66, and $71) *remain unchanged* from the previous fiscal year.

Lodging Rates: Lodging rates for locations listed in the per diem rate table will range from $77 to $296 in fiscal year 2012. **(Code §162; Per Diems)**

IRS Issues Summer Statistics of Income Bulletin (IR-2011-86)

The summer 2011 issue of the Statistics of Income Bulletin focuses on sole proprietorship data for 2009. In 2001, approximately 126,000 sole proprietorship returns reported as single-member LLCs. This increased by double digits each year (51% in 2003, 40% in 2004, and 47% in 2005) so that the number reporting as single-member LLCs equaled 992,000 in 2009 (i.e., almost a 800% increase since 2001). **(Misc.; SOI Bulletin)**

Comment: The Bulletin also has articles on:

(1) estate tax returns filed for decedents who died in 2007; (2) foreign-controlled domestic corporations; (3) interest-charge domestic international sales corporations; and (4) corporations claiming a foreign tax credit. For tax year 2007, 6,675 corporations claimed a total foreign tax credit of $86.5 billion against their U.S. income tax liability.

Closed-Loop Cooling System Treated as 7-Year MACRS Property (PLR 201131010)

A closed-loop system that provided cooling for multiple business tenants should be classified as 7-year MACRS property. This was because the system did *not* have a specified class life (i.e., as listed in **Rev. Proc. 87-56**, or any subsequent IRS pronouncement),and, more importantly, the IRS ruled that these assets were *not* "structural components" of the building (as would normally be the case with HVAC items such as new furnaces or boilers, installed when the building is first constructed, or otherwise undergoing significant rehabilitation). As a result, tangible personal property assets which have no MACRS classification are automatically placed in the 7-year class (i.e., recovery period) and given a 12-year midpoint.

Background: For purposes of the MACRS depreciation rules, the recovery period of an tangible personal property asset depends on its ADR classification which, in turn, places it into one of the MACRS recovery periods (e.g., 3, 5, 7, 10, 15 or 20 years). (**Code §168(e)(1)**) The ADR classification system is reproduced in **Rev. Proc. 87-56**. As stated above, however, under **Code §168(e)(3)(C)(v)**, if a certain type of property does *not* have a specific ADR class life and is *not* specifically assigned to any other MACRS class (such as solar panels specifically being assigned to the MACRS 5-year class under **Code §48**), then the asset, by default, is assigned to the 7-year class.

> **Comment**: When tangible personal property is placed into the MACRS 7-year class by default, it does *not* have any effect on how it may otherwise be depreciated (i.e., what depreciation method or convention is used). In other words, the normal 200%DB method can be used. Or, "AMT depreciation" can instead be opted for by using the 150%DB method over either the MACRS recovery period, or the longer midpoint which, in this case with the default classification, would be 12 years. Finally, the S/L method can also be used over either the MACRS recovery period or the midpoint. Also, such property is eligible for bonus depreciation if it meets the definition of "qualified property" in **Code §168(k)(2)**, as well as the **Code §179** immediate expensing election.

HVAC Rules: "Tangible personal property" for depreciation purposes does *not* include assets that are structural components of buildings or other inherently permanent structures. **Reg. §1.48-1(e)(2)**, defines the term "structural components" as including all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts, and other components relating to the operation or maintenance of a building.

Facts: Normally, "district heating and cooling systems" produce steam, hot water, or chilled water at a central plant and then pipe that energy out through a municipal "loop" to buildings in the district for space heating, domestic hot-water heating, and air conditioning. The main advantage is that individual buildings that take are part of a district heating and cooling provider do *not* need their own boilers or furnaces, chillers, or cooling towers. The assets of a district cooling system consist of a central chilled-water plant, a chilled-water supply line (which is usually underground), off-take points to individual buildings, and a return line to bring the water back to the central plant. The assets in the plant include chillers, cooling towers, thermal storage galvanized steel coils, pumps and motors, electrical systems, chemical systems, plant wiring, plant piping, and control systems. Central chilled-water plants typically run on electricity, steam-turbine drives, or steam absorption.

In this instance, the system was a "closed loop," meaning that the water never left the miles of pipeline that constituted the delivery mechanism. The pipeline was generally laid underground, in trenches, below the city's streets, and the extensions to a customer's building connected to the customer's basement. Along the pipe, in the same below-ground trench, were wires (i.e., fiber-optic cable) that extended from the plant to the meters at each customer's location, which record usage for billing purposes and enable the company to monitor the use of its district cooling system. A building owner had its building's internal heating, ventilation, and air conditioning (HVAC) system connected to the company's chilled-water closed loop pipeline through a heat exchanger substation owned by the company. Despite all of this the company that owned this "district heating and cooling system" was *not* "public utility property" under **Code §168(i)(10)**.

IRS Ruling: The IRS ruled that the company's tangible depreciable property used in its business activity of circulating chilled water through a closed loop pipeline to customers' premises and which is property *not* having a specifically assigned ADR asset classification under **Rev. Proc. 87-56**, is treated as 7-year MACRS property under **Code §168(e)(3)(C)(v)** (with a 12-year midpoint for ADS purposes.

Alternative ADR Classifications: In reaching its conclusion that this property was *not* listed in any of the other ADR classes listed in **Rev. Proc. 87-56**, the Service considered these alternative ADR classifications:

- ADR asset class 49.4 of **Rev. Proc. 87-56** includes assets "used in the production and distribution of steam for sale" and are assigned a midpoint 28 years which puts them in the 20-year MACRS recovery class. Here,

however, the chilled water that is circulated in its cooling system does *not* change from a liquid to a vapor (i.e., steam) and is never actually accessed by its customers. Instead, it is the cold energy (i.e., thermal energy) transferred through the heat exchanger substation that is furnished by the company to its customers. The bottom line is that the company business activity of circulating chilled water through a closed loop pipeline to provide cooling to customers' buildings does *not* produce and distribute steam for sale and, therefore, is *not* described in ADR asset class 49.4.

- ADR asset class 49.3 of **Rev. Proc. 87-56**, includes assets "used in the gathering, treatment, and commercial distribution of water." Assets in this class have a midpoint of 50 years and, as a result, are classified as MACRS 20-year property. However, **Code §168(c)** assigns a recovery period of 25 years to "water utility property," which is defined in **Code §168(e)(5)** as including property that is "an integral part of the gathering, treatment, or commercial distribution of water" and that, without regard to **Code §168(e)(5)**, would be MACRS 20-year property. In this instance, none of the water transmitted through the closed loop underground pipes to buildings for cooling purposes is used by its customers and all of the water is then returned to the company's chiller plants. As a result, the company is technically *not* "distributing water to its customers." Furthermore, the district cooling system does *not* "gather and treat the water" used in that system. As a result, the company's business activity of circulating chilled water through a closed loop pipeline to provide cooling to customers' buildings is *not* described in ADR asset class 49.3.

- ADR asset class 46.0 of **Rev. Proc. 87-56** includes assets "used in the private, commercial, and contract carrying of petroleum, gas, and other products by means of pipe and conveyors." Assets in this class have a midpoint of 22 years and, therefore, are classified as MACRS 15-year property. But here, once again, this closed loop district cooling system is *not* "supplying water to customers." As a result, providing cooling through a closed loop system is *not* an "activity of carrying a product by pipe" and is therefore *not* described in ADR asset class 46.0.

Building Component Issue: With regard to this critical issue, especially when it comes to a building's HVAC's system, the IRS also favorably ruled that the tangible depreciable property this taxpayer used in its activity of circulating chilled water through a closed loop pipeline to a heat exchanger located in the customers' buildings would *not* be "structural components" (which normally would be part of the MACRS 39-year commercial building classification). In reaching this conclusion, however, the Service distinguished the Tax Court's decision in ***Samis*, 76 TC 609 (2009)**, which held that a separate power plant, used to supply hot water, along with hot and cold water for heating and air conditioning, to an apartment complex owned by third parties, was a "structural component." The IRS stated that this taxpayer's situation was different from ***Samis*** in that its system "was designed and operated to serve numerous customers, none of its facilities are dedicated to providing cooling for just one building, and customers could discontinue their relationship with the company and find another way to run their central air conditioning systems." **(Code §168; Cooling Systems)**

> **Comment:** The IRS has a string of successful decisions defending the position that HVAC is a structural part of a building and *not* a separate component or asset which can be classified as other than 27.5- or 39-year MACRS property. But, now, not only do you have this decision, but in the energy-saving area of assets, wind, solar and geothermal property not only qualify as MACRS 5-year property, but also for the **Code §25D** credit of 30% of their cost (without an overall cap, let alone Sec. 179 immediate expensing expensing and bonus depreciation).

Return Altered by Preparer After Taxpayer Signed It Not Treated as Filed (PTMA 2011-20 "Tax Return Preparer's Alteration of a Return")

The IRS has concluded that a tax return signed by a taxpayer that is subsequently altered by a return preparer without the taxpayer's knowledge and submitted to the IRS by the preparer does *not* constitute the filing of a valid tax return. In this instance, the alterations inflated income, deductions, credits, or withholding in order to generate a larger refund that the preparer then confiscates for himself.

Background: In general, a four-part test applies for determining whether a document is a valid tax return: (1) there must be sufficient data to calculate tax liability; (2) the document must purport to be a return; (3) there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and (4) the taxpayer must execute the return under penalties of perjury. (***Beard*, 86 TC 766 (1984), *aff'd* CA-6**) This has come to be known as the "***Beard*** test" or the "substantial compliance standard." Under **Code §6005**, generally, any return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regs has to contain or be verified by a written declaration that it is made under penalties of perjury. But a return that does *not* comply with **Code §6005** fails the fourth prong of the "***Beard*** test." The requirement that a return be executed under penalties of perjury is absolute. Signing the jurat included on a Form 1040 (or **Form 8879**, for electronically filed tax returns), satisfies the requirement that the return is executed under the penalties of perjury.

Abusive Tax Return Preparer Behavior: The PMTA, which is addressed to the National Taxpayer Advocate Special Counsel, addresses preparer abuse that takes the following form: A client return is altered after the taxpayer reviews and signs it (or, for e-filed returns, the taxpayer signs **Form 8879, IRS e-file Signature Authorization**) by overstating income, deductions, credits, or withholding without the

taxpayer's knowledge and is then submitted by the return preparer to the IRS. The inflated income, deductions, credit, or withholding creates a larger than expected refund and the return preparer then keeps the portion of the refund resulting from the inflated items.

Comment: Although it was *not* specifically mentioned in the PMTA, a refund anticipation loan may have been part of the scheme in these cases. That is, when the refund is issued, the taxpayer does *not* know of the alterations because the refund amount he receives equals the amount of refund claimed on the tax return that he had originally approved for filing with the IRS.

IRS Ruling: The PMTA concludes that if the taxpayer is unaware of a preparer's fraudulent alteration of items of income, deductions, credits, or withholding after the taxpayer signed the tax return (or, the Form 8879), it cannot be treated as if the taxpayer executed the document under penalties of perjury. In fact, the document actually submitted to the IRS by the preparer is *not* even the same document signed and approved by the taxpayer or authorized to be filed electronically with the IRS. Thus, a return altered in this fashion by a tax return preparer does *not* meet the requirements set forth in ***Beard*** to constitute a valid tax return. **(Code §6005; Altered Tax Returns)**

Comment: Another side issue arises insomuch as, since a valid return has *not* been filed, then the statute of limitations would *not* begin to run until the taxpayer signs and submits a correct, unaltered return.

☞**Statistical Sampling Methods for Various Tax Purposes Updated (Rev. Proc. 2011-42)**
The Service has provided updated guidance on the use and evaluation of statistical samples and sampling estimates that may be employed by taxpayers for a variety of purposes, including determining basis in stock acquired in transfer basis transactions, as well as in determining income attributable to domestic production activities for purposes of **Code §199**.

Basis of Stock Acquired in Transferred Basis Transactions: In **Rev. Proc. 2011-35**, the IRS provided procedures that a corporation (Acquiring) may use to establish its basis in stock of another corporation (Target) when it acquires the Target stock in a transferred basis transaction, including but *not* limited to reorganizations under **Code §368(a)(1)(B)** (i.e., type "B" reorganizations) Specifically, **Rev. Proc. 2011-35, §4.02**, provides procedures for the use of statistical sampling when a full survey is *not* feasible.

Statistical Sampling for Code §199 Purposes: In **Rev. Proc. 2007-35**, **§4**, for purposes of determining income attributable to domestic production activities for the **Code §199** deduction, the IRS said it would treat the use of statistical sampling under prescribed procedures as a "reasonable method" of:

(1) allocating gross receipts between domestic production gross receipts (DPGR) and non-DPGR under **Reg. §1.199-1(d)(1)**;

(2) determining whether gross receipts qualify as DPGR on an item-by-item basis under **Reg. §1.199-3(d)(1)**;

(3) allocating cost of goods sold (CGS) between DPGR and non-DPGR under **Reg. §1.199-4(b)(2)(i)**; and

(4) allocating deductions that are properly allocable to DPGR or gross income attributable to DPGR under **Reg. §1.199-4(c)(1)**.

Statistical Sampling for M&E Expenses: The statistical sampling methods spelled out in **Rev. Proc. 2004-29** may be used by a taxpayer in connection with establishing the amount of its substantiated expenses for meals and entertainment that are *not* subject to the **Code §274(n)(1)** 50% deduction disallowance rule because of:

(1) **Code §274(n)(2)(A)**, which excepts expenses treated as employee wages or included in the income of a non-employee (e.g., independent contractor);

(2) payments to a contractor for M&E expenses (i.e., 50% limit does *not* apply to the payor if expenses are *not* accounted for to the payor, and 50% limit does *not* apply to the payee if he accounts for expenses to the payor);

(3) recreational and similar expenses for employees; items made available to the public; and entertainment sold to customers;

(4) **Code §274(n)(2)(B)**, which excepts meal expenses that are excludible as "de minimis fringes;"

Comment: These fringes are any property or service, the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to its employees) "so small as to make accounting for it unreasonable or administratively impracticable." Nevertheless, a *cash* fringe benefit (other than overtime meal money and local transportation fare) is never excludible as a "de minimis fringe."

(5) **Code §274(n)(2)(C)**, which excepts expenses covered by a package involving a ticket to certain charitable sports events;

(6) **Code §274(n)(2)(D)**, which excepts an employer's payment or reimbursement of certain employee moving expenses; and

(7) **Code §274(n)(2)(E)**, which excepts certain meals required by Federal law to be provided to crew members of a commercial vessel, or meals provided to crew members of certain commercial vessels or on or in proximity to certain oil or gas platforms or drilling

rigs. (**Rev. Proc. 2004-29, §3**)

Other Areas Appropriate for Statistical Sampling: Other areas where statistical sampling may be used include an external auditor's use of sampling under a qualified intermediary (QI) withholding agreement with the IRS, (**Rev. Proc. 2002-55**), and determining the redemption reserve for trading stamps or premium coupons (**Rev. Proc. 1972-2**).

New Sampling Guidance Under Rev. Proc. 2011-42: Rev. Proc. 2011-42, provides that when permitted by the IRS, a taxpayer may use statistical sampling in establishing, with respect to its income tax liability, items on its return by following the procedures provided in **Rev. Proc. 2011-42 Appendix A (Sampling Plan Standards), Appendix B (Sampling Documentation Standards)**, and **Appendix C (Technical Formulas).** It also establishes the ground rules for applying these sampling methods.

> **Comment: Rev. Proc. 2011-42**, *modifies and amplifies* the guidance in **Rev. Proc. 2007-35**, **Rev. Proc. 2004-29**, **Rev. Proc. 2002-55**, and **Rev. Proc. 72-36**.

Effective Date: Rev. Proc. 2011-42 applies for tax years ending on or after Aug. 19, 2011. With respect to the use of statistical sampling by a taxpayer for a tax year ending before that date, for which the applicable period of limitations has *not* expired, the IRS will permit, but will *not* require, application of **Rev. Proc. 2011-42**. **(Misc.; Statistical Sampling)**

Final Regs Issued on Deducting Start-Up and Organizational Expenses (T.D. 9542)

The IRS has issued final regs on the election to deduct start-up expenses under **Code §195**, corporate organization expenses under **Code §248**, or partnership organization expenses under **Code §709**. Specifically, the regs reflect changes made to these provisions by the American Jobs Creation Act of 2004.

Background: The American Jobs Creation Act of 2004 amended the treatment of start-up and organizational expenses paid or incurred after Oct. 22, 2004 (i.e., its enactment date) to provide as follows:

- Under **Code §195(b)**, an electing taxpayer is allowed to deduct in the tax year in which the taxpayer begins an active trade or business the *lesser* of: (1) the amount of the start-up expenditures that relate to the active trade or business; or (2) $5,000, reduced (but not below zero) by the amount by which the start-up expenditures exceed $50,000. The remainder of the start-up expenditures is then amortized ratably over the 180-month period beginning with the month in which the active trade or business begins.

> **Comment:** The Tax and Pension Provisions of the Small Business Jobs Act of 2010 increased the amount of start-up (but *not* **Code §248** organizational) expenses that a taxpayer could elect to deduct for a tax year beginning in 2010 from $5,000 to $10,000. It also increased the deduction phaseout threshold so that the $10,000 was reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeded $60,000.

- Under **Code §248(a)**, an electing corporation is allowed to deduct in the tax year in which the corporation begins business the *lesser* of: (1) the amount of the corporation's organizational expenditures; or (2) $5,000, reduced (but not below zero) by the amount by which the organizational expenditures exceed $50,000. The remainder of the organizational expenditures is amortized ratably over the 180-month period beginning with the month in which the corporation begins business.

- Under **Code §709(b)**, an electing partnership is allowed to deduct in the tax year in which the partnership begins business the *lesser* of (1) the amount of the partnership's organizational expenses; or (2) $5,000, reduced (but not below zero) by the amount by which the organizational expenses exceed $50,000. The remainder of the organizational expenses is amortized ratably over the 180-month period beginning with the month in which the partnership begins business.

> **Comment:** Note, that even though the immediate expensing of start-up costs was doubled from $5,000 to $10,000, this did not affect the immediate write-off of organizational costs under either **Code §248** or **Code §709** which remains at just $5,000.

Proposed Regs: The proposed regs covering these Code sections eliminated the need to make a formal election to deduct start-up expenses and instead provided that taxpayers were deemed to have made the applicable election for the year in which the active trade or business begins, or the year in which the corporation or partnership begins business.

Final Regs: The final regs adopt the proposed regs with minimal change. One thing that the final regs sought to clarify what was meant in the proposed regs when it stated that a taxpayer had to "clearly electing to capitalize" start-up and organizational costs (i.e., instead of expensing the first $5,000 or $10,000, and then amortizing the remaining costs) by "affirmatively electing to capitalize" the costs on a timely filed Federal income tax return. (**Reg. §1.195-1(b), Reg. §1.248-1(c), Reg. §1.709-1(b)(2)**) So, the final regs, like the proposed regs, contain examples illustrating how the election is made, how to calculate the amount of the deduction that is allowed in the year in which the election is made, and how to effect subsequent redeterminations in the characterization of an item or the year in which the trade or business begins. (**Reg. §1.195-1(c), Reg. §1.248-1(e), Reg. §1.709-1(b)(4)**)

Effective Date: The regs are effective for expenses paid or incurred after Aug. 16, 2011. However, taxpayers may apply all the provisions of the final regs to expenses paid or incurred after Oct. 22,

2004, if the period of limitations on assessment of tax has *not* expired for the year the election under **Code §195**, **Code §248**, or **Code §709** is deemed made. (**Code §§195**, **248** & **709**; **Start-up & Organizational Costs)**

☞11th Circuit Finds Health Care Law's Individual Mandate Unconstitutional - Circuit Courts Now Split (*Florida v. HHS*, 108 AFTR 2d ¶ 2011-5187 (11th Cir., 8/12/2011))

In a 2-1 decision, the 11th Circuit has held that the individual insurance mandate in the Health Care Act is unconstitutional, while holding the remainder of the law constitutional. The most important thing, perhaps, is that this decision now creates a split among the Circuit Courts of Appeal. **(Misc.; Health Care Act)**

> **Comment:** The result of this split is that this issue will now be heard by the Supreme Court which may or may not render its decision before the 2012 presidential election is decided.

FROM CONSULTING CALLS:

☞Tax Provisions Set to Expire at Yearend

The following is a summary of those tax provisions which are set to expire at 12/31/2011 (unless Congress acts to extend them beyond yearend). As a result, planning for those clients who wish to take advantage of a particular break should completed over the next several months.

Tax Credits: The following is a list of tax credits which are schedule to expire at 12/31/2011:

- **Research credit:** The research credit only applies for amounts paid or accrued *before* Jan. 1, 2012. (**Code §41(h)(1)**) In general, the research credit equals the sum of: (1) 20% of the *excess* (if any) of the qualified research expenses for the tax year over a base amount, (unless the taxpayer elected an "alternative simplified research credit"); (2) the university basic research credit (i.e., 20% of the basic research payments); and (3) 20% of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium.

- **Work Opportunity Tax Credit:** The WOTC allows employers who hire members of certain targeted groups to get a credit against income tax of a percentage of first-year wages up to $6,000 per employee ($12,000 for qualified veterans; and $3,000 for qualified summer youth employees). Where the employee is a long-term family assistance (LTFA) recipient, the WOTC is a percentage of first and second year wages, up to $10,000 per employee. Generally, the percentage of qualifying wages is: (1) 40% of first-year wages; or (2) 25% for employees who have completed at least 120 hours, but less than 400 hours of service for the employer. For LTFA recipients, it includes an additional 50% of qualified second-year wages. However, the term "wages" for WOTC purposes does *not* include any amount paid or incurred for an individual who begins work *after* Dec. 31, 2011. (**Code §51(c)(4)**)

- **New markets tax credit:** Under **Code §45D**, a taxpayer who holds a "qualified equity investment" in a "qualified community development entity" (CDE) may be entitled to a NMTC. The credit is 39% of the qualified equity investment during a 7-year credit period. The investor may claim 5% in each of the first 3 years and 6% in each of the final 4 years. There is a national, annual limitation on the amount designated under **Code §45D**. But, under current law, the last NMTC dollar limitation is for 2011. (**Code §45D(f)(1)**)

- **Differential wage payment credit for employers:** Under **Code §45P**, "eligible small business employers" that pay "differential wages" can claim a credit equal to 20% of up to $20,000 of differential pay made to an employee during the tax year. "Differential wages" are defined as payments to employees for periods that they are called to active duty with the U.S. uniformed services (for more than 30 days) that represent all or part of the wages that they would have otherwise received from the employer. An "eligible small business employer" is one that: (1) employed on average less than 50 employees on business days during the tax year; and (2) under a written plan, provides eligible differential wage payments to each of its qualified employees. A "qualified employee" is one who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made. Nevertheless, this credit will *not* be available for differential wages paid *after* Dec. 31, 2011. (**Code §45P(f)**)

- **New energy efficient home credit:** An "eligible contractor" can claim a credit of $2,000 or $1,000 for each "qualified new energy efficient home" either constructed by the contractor or acquired by a person from the contractor for use as a residence during the tax year. However, the credit will *not* apply to homes acquired *after* Dec. 31, 2011. (**Code §45L(g)**)

Tax Deductions: The following is a list of deductions which will no longer be available after 12/31/2011:

- **100% bonus depreciation:** The 100% bonus depreciation allowance applies only for qualified property acquired and placed in service *after* Sept. 8, 2010 and *before* Jan. 1, 2012 (a longer transitional "placed-in-service" date applies (i.e., before Jan. 1, 2013) for certain aircraft and long-production-period property). However, 50% bonus depreciation rules will continue to apply for qualified property acquired and placed in service *after* Dec. 31, 2011 and *before* Jan. 1, 2013 (**Code §168(k)(1)**, **Code §168(k)(5)**)

- **Sec. 179 immediate expensing allowance:** The maximum amount that may be expensed under **Code §179** for tax years beginning in 2010 or 2011 is $500,000. For tax years beginning in 2012, the maximum amount will be $125,000 (indexed for inflation with 2006 as the base year). For tax years beginning in 2010 and 2011, the maximum annual

expensing amount generally is reduced dollar-for-dollar by the amount of section 179 property placed in service during the tax year in excess of $2,000,000 (i.e., the "investment ceiling"). For tax years beginning in 2012, the investment ceiling will be $500,000 (indexed for inflation with 2006 as the base year). (**Code §179(b)**)

> **Comment:** An additional $250,000 write-off under **Code §179** is available for "qualified real property," if placed in service in a tax year beginning in 2010 or 2011. (**Code §179(f)(1), Code §179(f)(3)**) "Qualified real property" is one of the following types of property: (1) qualified leasehold improvement property, (2) qualified restaurant property or (3) qualified retail improvement property. (**Code §179(f)(2)**)

> **Comment:** Always keep in mind that leases between related parties are *not* "qualified leases" for purposes of the "qualified leasehold improvement" rules. As a result, such improvements would have to be depreciated over the normal 39-year MACRS recovery period for commercial property (and, would also *not* be eligible for bonus depreciation since they are *not* in a MACRS classlife of 20 years or less).

- 15-year writeoff for specialized realty assets: Qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property placed in service after Dec. 31, 2011, will no longer be eligible for the 15-year MACRS recovery period. (**Code §168(e)(3)(E)(iv), Code §168(e)(3)(E)(v)**, and **Code §168(e)(3)(E)(ix)**) Instead, such property will have to be depreciated over the 39-year MACRS recovery period for commercial real estate.

Enhanced Charitable Contribution Deductions: The following enhanced charitable contribution rules will *not* apply to contributions made *after* Dec. 31, 2011:

- Enhanced charitable deductions for C corporations:

1) Food donations: A C corporation's enhanced charitable contribution deduction equal to the *lesser* of: (a) basis plus half of the property's appreciation, or (b) twice the property's basis, for contributions of food inventory that is "apparently wholesome food" (i.e., meant for human consumption and meeting certain quality and labeling standards).

> **Comment:** The enhanced contribution is also available for a taxpayer other than a C corporation, but the aggregate amount of contributions of "apparently wholesome food" that may be taken into account for the tax year is *not* permitted to exceed 10% of the taxpayer's aggregate net income for that tax year from all trades or businesses from which those contributions were made for that tax year. (**Code §170(e)(3)(C)(iv)**)

2) Book donations: A C corporation's enhanced charitable contribution deduction equal to the *lesser* of (a) basis plus half of the property's appreciation, or (b) twice the property's basis, for qualified contributions of book inventory to certain public schools if certain donee certification requirements are met. (**Code §170(e)(3)(D)(iv)**)

3) Computer technology or equipment donations: A C corporation's enhanced charitable contribution deduction equal to the *lesser* of: (a) basis plus half of the property's appreciation, or (b) twice the property's basis, for certain contributions of computer technology or equipment (e.g., software, computer or peripheral equipment, and fiber optic cable) to schools or libraries for use in the U.S. for educational purposes that are related to the donee's purpose or function. (**Code §170(e)(6)(G)**)

Reduced Stock Basis Adjustment for S Corp Shareholders: Lower shareholder stock basis adjustments for charitable contributions by S corporations are available for donations made by 12/31/2011. The law provides for a temporary tax incentive to encourage S corporations to make charitable donations of appreciated assets. But, it is only available for contributions made in tax years beginning *before* Jan. 1, 2012 (**Code §1367(a)(2)**) Generally, an S corporation's charitable contribution of property provides its shareholders with a fair market value deduction for gifts of property. However, when charitable gifts are made by the S corporation, shareholders are required to reduce their basis of shares in the corporation. Under the temporary incentive, shareholders reduce their basis in the stock of the S corporation by their pro rata share of the *adjusted basis* of the contributed property, instead of the FMV of the charitable contribution that flows through to the shareholder. Correspondingly, this lower basis reduction results in a proportionately lower gain when the stock is later sold by the shareholder. In other words, the shareholder benefits by having their stock basis reduction determined by the adjusted basis of the property donated (i.e., which will be a smaller amount with gifts of appreciated property).

Expensing Election for Costs of Film and TV Production: Taxpayers may elect to expense production costs of qualified film and television (TV) productions in the U.S., but only for productions commencing *before* Jan. 1, 2012. (**Code §181(f)**) However, this special expensing election does *not* apply to the part of the cost of any qualifying film or TV production that exceeded $15 million for each qualifying production. The limit is $20 million if production expenses are "significantly incurred" in certain low-income communities or isolated areas of distress.

Expensing of Environmental Remediation Costs: Taxpayers may elect to treat "qualified environmental remediation expenses" that would otherwise be chargeable to a capital account as deductible in the year paid or incurred, but only if the expenses are paid or incurred *before* Jan. 1, 2012.

(**Code §198(h)**) But, to be deductible currently, pre-2012 expenses must be paid or incurred in connection with the abatement or control of hazardous substances (including petroleum products) at a "qualified contaminated site."

Domestic Production Activities Deduction for Puerto Rico: The **Code §199** domestic production activities deduction is available only if, among other conditions, the taxpayer has domestic production gross receipts (DPGR) from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the U.S.; (2) any sale, exchange, etc., of qualified films produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the U.S.; (4) construction activities performed in the U.S.; or (5) engineering or architectural services performed in the U.S. for construction projects located in the U.S. For a taxpayer's first six tax years beginning after 2005 and *before* Jan. 1, 2012, Puerto Rico is included in the term "U.S." in determining DPGR, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the federal income tax for individuals or corporations. (**Code §199(d)(8)(C)**)

Empowerment Zone Tax Breaks: The designation of an "economically depressed census tract" as an "Empowerment Zone" makes businesses and individual residents within such a Zone eligible for special tax incentives, including: the 20% wage credit under **Code §1396**; liberalized **Code §179** expensing rules (i.e., $35,000 extra expensing and only having to count 50% of expensed eligible property to be counted for purposes of the overall investment-based phaseout of expensing); tax-exempt bond financing under **Code §1394**; and deferral under **Code §1397B** of capital gains tax on sale of qualified assets sold and replaced. However, "empowerment zone" designations expire on Dec. 31, 2011. (**Code §1391(d)**)

Miscellaneous Provisions Expiring on Dec. 31, 2011: The following is a list of other tax provisions which are scheduled to expire on 12/31/2011:

- The 7-year straight line cost recovery period for motorsports entertainment complexes will *not* apply for property placed in service *after* Dec. 31, 2011. (**Code §168(i)(15)(D)**)

- The Indian employment credit only applies for tax years beginning *before* Jan. 1, 2012. (**Code §45A(f)**)

- Accelerated depreciation for qualified Indian reservation property applies for property placed in service before 1/1/ 2011. (**Code §168(j)**)

- The railroad track maintenance credit applies through 2011. (**Code §45G(f)**)

- The mine rescue team training credit applies through 2011. (**Code §45N(e)**)

- For tax years beginning *after* Dec. 31, 2008, and *before* Jan. 1, 2012, the 100%-of-taxable-income limitation of percentage depletion for oil and gas from marginal wells applicable to independent producers and royalty holders owning interests in marginal wells is suspended. For tax years beginning *on or after* Jan. 1, 2012, the 100% of the taxable income limit returns for marginal wells. (**Code §613A(c)(6)(H)**)

- A taxpayer may claim a 30% credit for the cost of installing "qualified alternative vehicle refueling property" for use in the taxpayer's trade or business (up to $30,000 maximum per year per location) or installed at the taxpayer's principal residence (up to $1,000 per year per location). However, this credit will *not* apply to property (except for hydrogen refueling property) placed in service *after* Dec. 31, 2011. (**Code §30C(g)(2)**)

- Under the "energy efficient appliance credit" provision, for appliances produced in 2011, and depending on their specifications, manufacturers can claim a: (i) $25, $50, or $75 credit for each qualifying dishwasher; (ii) $175 or $225 credit for each qualifying clothes washer; (iii) $150 or $200 credit for each qualifying refrigerator. (**Code §45M**)

- The designation of the District of Columbia Enterprise Zone (DC Zone) under **Code §1400(f)** applies through Dec. 31, 2011. (**Code §1400(f)**) This designation makes businesses and individual residents within the Zone eligible for special tax incentives, including additional expensing under **Code §179** and a 20% wage credit under **Code §1396** for eligible DC Zone employers.

- The election to expense 50% of the cost of advanced mine safety equipment applies through 2011. (**Code §179E(g)**)

- The increase in the limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands applies through 2011. (**Code §7652(f)**)

- The American Samoa economic development credit applies for the first six tax years of a taxpayer beginning *after* Dec. 31, 2005 and *before* Jan. 1, 2012. **(Misc.; Expiring Tax Provisions)**

☞**Calculating RMDs From Defined Contribution Plan (IRS Employee Plans News - Issue 20011-5)** The IRS has provided a good summary of the steps necessary to calculate a participant's required minimum distribution (RMD) from a defined contribution plan.

Background: A defined contribution plan is required to make RMDs to a participant by the *later* of: (1) April 1st of the calendar year following the year in which the participant reaches age 70½; or (2) retires from the employer maintaining the plan (if delaying RMDs is allowed by the terms of the plan). However, if the plan participant is a "5% owner" of the employer maintaining the plan, then the RMDs must start by April 1st of the calendar year following the year in which the

participant reaches age 70½.

RMD Calculation: Calculating the RMD depends on the type of defined contribution plan involved. Most defined contribution plans, as, for example, 401(k) and profit-sharing plans, must comply with **Reg. §1.401(a)(9)-1** through **-9. 401(k)** and profit-sharing plans must calculate RMDs by dividing the participant's account balance at the end of the calendar year *prior* to the year in which the RMD is to be made by using the appropriate number from either: (1) the Joint Life and Last Survivor Expectancy Table (which is for a married participant whose spouse is *more than* 10 years younger than the participant and is the sole beneficiary of the participant); or (2) the Uniform Lifetime Table, which is for *all* other participants. SEP and SIMPLE IRA plans are also considered to be defined contribution plans, but are instead governed by the **Reg. §1.408-8** IRA RMD rules. Meanwhile, 403(b) plans mostly follow the IRA rules.

> **Comment:** On the other hand, other distinct RMD rules apply to defined benefit plans.

As stated above, a participant's first year's RMD can be made as late as April 1st of the year following the year in which the plan participant turned 70½. As an alternative, a plan is allowed to instead purchase an annuity, or use a shorter period than those listed in the Tables mentioned above, to distribute the participant's account balance.

Participant Dies On or After RMDs Begin: If a participant dies *on or after* RMDs begin, the participant's account balance should be divided at the end of the calendar year *prior to* the year in which the RMD is to be made by the applicable number (i.e., remaining life expectancy) in the Single Life Expectancy Table depending on who the beneficiary is, as follows:

- When there is **no designated beneficiary**, the participant's life expectancy that would have otherwise remained as of the date of death is to be used. For example, take the participant's age at his birthday in the year of death and subtract one to calculate the RMD for the year *after* the year of death. Then, in each subsequent calendar year, *reduce the number by one* for each calendar year since the year of the participant's death.

- When there **is a designated beneficiary**, if the beneficiary is a *nonspouse* beneficiary (or, when the spouse is *not* the sole beneficiary), use the beneficiary's remaining life expectancy based on the beneficiary's age in the calendar year *after* the calendar year in which the participant died. Then, in each subsequent calendar year, reduce the number by one for each calendar year since the year of the participant's death. If there are multiple beneficiaries, use the beneficiary with the *shortest* life expectancy. On the other hand, if the beneficiary is a spouse (and, they are the sole designated beneficiary), use the surviving spouse's life expectancy based on their age in each distribution calendar year after the participant dies. And, if the spouse subsequently dies, then continue to use the spouse's life expectancy based on his or her age at death, reducing the number by one for each calendar year since the spouse's death.

> **Comment:** For *both* spouse and nonspouse beneficiaries, if the RMD determined for "no designated beneficiary" as outlined above is *smaller*, then that method should be used.

Direct Spousal Rollover: A plan is required to offer a nonspouse beneficiary the opportunity to directly roll over an inherited plan account to an inherited IRA.

Participant Dies 0n or Before RMDs Begin: If a participant dies *on or before* RMDs begin, this IRS guidance states that "similar methods" as used when the participant dies on or after RMDs begins should be use, except: (a) if there is **no designated beneficiary** (or, if allowed by the terms of the plan), the participant's entire account must be distributed by December 31st of the *fifth* year following the year of death; and (b) if there **is a designated beneficiary**, RMDs must be based solely on the beneficiary's remaining life expectancy (i.e., the participant's life expectancy cannot be used). **(Code §401; RMDs)**

> **Comment:** A very important special rule should be kept in mind with it comes to inherited IRAs. Namely, for any IRA inherited last year (i.e., 2010), the IRA's beneficiaries are set on Sept. 30th of the year following the death of the IRA owner. And, normally, nonspousal heirs get to take distributions from inherited IRAs over their lifetimes. But, if just one beneficiary of the account is *not* an individual, the IRA must instead be depleted within five years for all beneficiaries. This issue can arise when a decedent names a charity or college as one of the beneficiaries. But, redeeming a non-individual's IRA interest by Sept. 30th can be excellent tax planning. If the charity, school, etc., is paid off by then, the remaining individual beneficiaries can take distributions over their lives, thereby benefitting from additional tax-deferred buildup of the assets inside the IRA.

☞When Is Withholding Required for Retirement Plan Distributions?

Distributions from an employer-sponsored retirement plan may or may not be subject to withholding depending on the nature of the payment. In some cases, withholding is mandatory, and in others the recipient can elect out.

> **Comment:** The Summer 2011 edition of IRS's **Retirement News for Employers** provides an excellent summary of the current rules for both payors and payees.

Withholding on Eligible Rollover Distributions: In general, the payor of any "designated

distribution" that is an "eligible rollover distribution" must withhold an amount equal to 20% of the distribution. A "designated distribution" is a distribution or payment from, or under: (1) an employer deferred compensation plan, (2) an IRA or individual retirement annuity; or (3) a commercial annuity. An "eligible rollover distribution" generally is a plan distribution from an "eligible retirement plan" (i.e., plan distributions other than periodic distributions, minimum required distributions, or hardship distributions). (**Code §3405**) Most importantly, the recipient of a distribution that is otherwise subject to 20% withholding is *not* permitted to elect out of the withholding requirement. (**Reg. §31.3405(c)-1**) However, "eligible rollover distributions" are *not* subject to withholding if expected distributions to an individual are *less than* $200 for the year. Also, 20% withholding generally only applies to any previously untaxed amount of an eligible rollover distribution. Nevertheless, the most important exception is that no withholding is required if the plan *directly rolls over* (i.e., in a trustee-to-trustee transfer) the eligible rollover distribution amount to another qualified retirement plan or IRA.

Periodic Payments: The payor of a "periodic payment" (i.e., one made at regular intervals for more than one year, such as an annuity) that is *not* an "eligible rollover distribution" must withhold from the payment as if it were a wage payment for the appropriate payroll period. (**Code §3405(a)(1)**) In this regard, the plan administrator is required to withhold at the rate for a married individual with 3 withholding exemptions. However, recipients have the right (and must be so informed by the plan administrator) to: (1) elect no withholding or elect to have a different amount withheld, by filing **Form W-4P, Withholding Certificate for Pension or Annuity Payments**, with the plan administrator; and (2) revoke the election at any time.

Nonperiodic Payments: A "nonperiodic payment" is a distribution that usually is *not* made at regular intervals and is *not* an "eligible rollover distribution." Examples of nonperiodic payments would include:

- distributions of excess annual additions;

- distributions of excess contributions and excess aggregate contributions from most plans if made within 2½ months after the end of the plan year;

- hardship distributions; and

- loans treated as distributions.

Nonperiodic Payments Generally Subject to 10% Withholding: As stated above, despite normally being subject to withholding, the recipient may nevertheless elect to have no withholding, or have a different amount withheld by filing a Form W-4P with the plan administrator.

Special Situations: Plan administrators need to be aware that special rules apply to:

- distributions made because of recognized disasters;

- distributions delivered outside the U.S. or U.S. possessions;

- certain noncash distributions, including employer securities; and

- a participant's accrued benefit offset because of a defaulted loan.

Designated Roth Accounts: For distributions from designated Roth accounts in 401(k), 403(b), or 457(b) plans, payors and payees should be reminded that there is no withholding required for a qualified distribution from a designated Roth account because the distribution is *not* otherwise taxable. If a nonqualified distribution is made from such an account, withholding is required only from any distributed earnings that the recipient must include in gross income. **(Code §401; Pension Plan Distributions)**

☞Roth Pay-Ins Recommended for Children's Summer Earnings

This suggestion makes a lot of sense where your client's children (or, grandchildren) are successfully holding down a job over the summer months. Consideration should be given to making a pay-in to a Roth IRA. Up to $5,000 can be contributed, but *not* more than the child's actual earned income. Just remember that what a parent or grandparent contributes would count toward the $13,000 annual gift tax exclusion ($26,000 if you split the gift with your spouse). The bottom line is that, with compounding, it is truly surprising what such a small sum can grow to over the years. For instance, a single $5,000 contribution to a 16-year-old's Roth that earns 8% each year will grow to $217,000 at age 65 and $319,000 at age 70. And, if the child works for a few summers and contributions are made each year, the future balance in the account could obviously be significantly larger. In addition, withdrawals of the earnings on a Roth IRA have the advantage of being tax-free after 59½. But, in the short term, the child is permitted to extract any pay-ins tax-free, which could be handy when it comes to the downpayment on a first home, for example. **(Code §408A; Roth IRAs)**

Yours very truly,
John J. Connors
Prof. John J. Connors,
J.D., C.P.A., LL.M.

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Debra, founder of Petersen Law, specializes in tax and estate planning and is an adjunct professor with the University of Pacific's McGeorge School of Law. Debra worked for the California Franchise Tax Board for 18 years, and prior to that she worked for Arthur Andersen & Co. and Coopers & Lybrand. Debra will be speaking at Spidell's 2011 2-Day Estate and Trust Seminar.

Robert Manton, CPA
Robert is a partner with the firm McNally & Manton, CPAs Inc., serving the Orange County and Los Angeles areas for over 35 years. Estate and trust taxation has been his niche and specialty for over 20 years. He teaches estate and trust seminars, including in-house programs for large firms. He is known for his to-the-point speaking style and his ability to provide practical solutions to everyday situations. Robert will be speaking at Spidell's 2011 2-Day Estate and Trust Seminar.

Donita Joseph, CPA, MBT
Donita is a partner with Windes & McClaughry Accountancy Corp. in Long Beach, California. She is the partner in charge of the firm's Estate & Trust Group, and she is currently the Chair of the Committee on Estate Planning for the California Society of Certified Public Accountants (CalCPA).

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