

Individual Taxation: Filing Season Update

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This article covers recent significant developments affecting taxation of individuals, including cases, regulations, and legislative changes, and important information for the upcoming filing season. The items are arranged in Code section order.

Sec. 1: Tax Imposed

Kiddie tax: Under the kiddie tax, minor children's unearned income is taxed at their parents' highest rate.¹ The kiddie tax has been expanded for 2008. For 2007, it applied to the unearned income of children under age 18. It now applies to investment income of children under age 19 and certain children under age 24. Specifically, the kiddie tax now applies to a child aged 19–23 if:

1. The child is a full-time student before the close of the tax year; and
2. The child's earned income does not exceed one-half of his or her support.

For tax years beginning in 2008, the minimum basic standard deduction amount used to reduce the net unearned income reported on the child's return that is subject to the kiddie tax is \$900.² The same \$900 amount is also used to determine whether a parent may elect to include a

child's gross income in the parent's gross income and to calculate the kiddie tax.³

Capital gains: Taxpayers in the 15% or lower tax brackets have a 0% capital gains rate for tax years beginning after 2007 and before 2011.⁴

Sec. 23: Adoption Expenses

The Fostering Connections to Success and Increasing Adoptions Act⁵ includes a provision that requires states to inform any individual who is adopting (or who the state is made aware is considering adopting) a child who is in foster care under the responsibility of the state of the potential eligibility of the individual for the Sec. 23 adoption credit.

For 2008, the credit allowed for the adoption of a child with special needs is \$11,650;⁶ the maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to \$11,650.⁷ The

1 Sec. 1(g).

2 Sec. 1(g)(4)(A)(ii)(I).

3 Sec. 1(g)(7).

4 Sec. 1(h)(1)(B).

5 Fostering Connections to Success and Increasing Adoptions Act, P.L. 110-351.

6 Sec. 23(a)(3).

7 Sec. 23(b)(1).

available adoption credit phases out for taxpayers with modified adjusted gross income (AGI) between \$174,730 and \$214,730.

Sec. 24: Child Tax Credit

The Tax Extenders Act (part of the Emergency Economic Stabilization Act)⁸ makes the Sec. 24 child tax credit refundable to the extent of 15% of the taxpayer's earned income in excess of \$8,500 (lowered from \$12,050 for 2008 only). The phaseout of the credit is unaffected.

Sec. 25A: Hope and Lifetime Learning Credits

For tax years beginning in 2008, a taxpayer's modified AGI in excess of \$48,000 (\$96,000 for a joint return) is used to determine the reduction in the amount of the Hope scholarship and lifetime learning credits otherwise allowable.⁹

Sec. 25D: Residential Energy-Efficient Property Credit

The Sec. 25D(g) residential energy-efficient property credit for qualified solar and fuel cell property expenditures has been extended for eight years, through 2016. In addition, a taxpayer may now claim the residential energy-efficient property credit against the alternative minimum tax (AMT).

Sec. 26: Limitation Based on Tax Liability

The Tax Extenders Act provides that under Sec. 26(a)(2) the nonrefundable personal credits may offset the AMT.

Sec. 32: Earned Income Credit

For 2008, the AGI limits for the earned income credit increase. For single taxpayers who had one child living with them, the threshold phaseout amount is \$15,740 (\$18,740 if married filing jointly) and the completed phaseout amount is \$33,995 (\$36,995 if married filing jointly). For single taxpayers who had two or more children living with them, the threshold phaseout amount is \$15,740 (\$18,740 if

married filing jointly) and the completed phaseout amount is \$38,646 (\$41,646 if married filing jointly). For single taxpayers with no child living with them the threshold phaseout amount is \$7,160 (\$10,160 if married filing jointly) and the completed phaseout amount is \$12,880 (\$15,880 if married filing jointly).¹⁰

The maximum investment income a taxpayer can have and still get the credit has increased to \$2,950.¹¹

Effective for tax years ending after December 31, 2007, the Heroes Earnings Assistance and Relief Act of 2008¹² makes permanent the election first introduced by the Working Families Tax Relief Act of 2004¹³ to treat tax-free combat pay as earned income for purposes of the earned income tax credit.¹⁴

Sec. 36: First-Time Homebuyer Credit

Introduced by the Housing Assistance Tax Act of 2008,¹⁵ new Sec. 36 grants a refundable first-time homebuyer's credit to eligible taxpayers. The credit, computed as the lesser of \$7,500 (\$3,750 for married taxpayers filing separately) or 10% of the purchase price of the home, applies to principal residence purchases made after April 8, 2008, and before July 1, 2009. Phased out for taxpayers with modified AGI income in excess of \$75,000 (\$150,000 for married taxpayers filing jointly), the credit must be claimed on 2008 tax returns and must be recaptured over a 15-year period starting in the second year following the year of purchase. The taxpayer claims the credit on new Form 5405, First-Time Homebuyer Credit.

To be eligible, a taxpayer must be a first-time homebuyer, defined as someone who has not had a present ownership interest in a principal residence during the three-year period ending on the date the principal residence is purchased.¹⁶ Also, the taxpayer must not have purchased the residence from a related party.

The residence purchased must be in the United States and must be purchased

EXECUTIVE SUMMARY

- A number of credits and other items that were scheduled to expire (or had already expired) were extended by the Tax Extenders Act. The act also increased the alternative minimum tax (AMT) exemption amount and made changes to the rules regarding the AMT minimum tax credit.
- The Housing Assistance Tax Act provided various credits and deductions for homeowners, including a refundable credit for first-time homebuyers. The Heroes Earnings Assistance and Relief Act provided benefits for members of the military and the intelligence community.
- Numerous changes affecting individuals were made in regulations and other guidance issued by the IRS, as well as in decisions by the Tax Court and other federal courts.

between April 8, 2008, and July 1, 2009. However, taxpayers who purchase a residence in 2009 (before July 1) may elect to treat the purchase as having taken place on December 31, 2008, for purposes of the credit.

Unmarried individuals may jointly purchase a residence and allocate the \$7,500 credit between them.¹⁷

8 Emergency Economic Stabilization Act, P.L. 110-343.

9 Sec. 25A(d)(2)(A)(ii).

10 Rev. Proc. 2007-66, 2007-45 I.R.B. 970, §3.07(1).

11 Sec. 32(i); Rev. Proc. 2007-66, §3.07(2).

12 Heroes Earnings Assistance and Relief Act of 2008, P.L. 110-245.

13 Working Families Tax Relief Act of 2004, P.L. 108-311.

14 Sec. 32(c)(2)(B)(vi).

15 Housing Assistance Tax Act of 2008, P.L. 110-289.

16 Sec. 36(c)(1).

17 Sec. 36(b)(1)(C).

Exhibit 1: Standard deduction amounts for 2008

Filing status	Standard deduction
Married individuals filing joint returns and surviving spouses	\$10,900
Heads of households	8,000
Unmarried individuals (other than surviving spouses and heads of households)	5,450
Married individuals filing separate returns	5,450

The IRS has issued IR-2008-106, which includes questions and answers that elaborate on which home purchases qualify, who cannot take the credit, and how and when the credit should be repaid.

Sec. 53: Credit for Prior Year Minimum Tax Liability

The Tax Extenders Act increases the AMT refundable credit amount for individuals with long-term unused minimum tax credits to 50%.¹⁸ It increases the refundable credit by 50% of interest and penalties that were paid by the taxpayer before October 3, 2008. It also allows an abatement of any underpayment of tax, interest, and penalties for tax years ending before January 1, 2008, attributable to incentive stock options (ISOs) due and unpaid as of October 3, 2008.¹⁹

Sec. 55: Alternative Minimum Tax

The Tax Extenders Act increases the AMT exemptions for 2008 to \$69,950 in the case of a joint return and \$46,200 for single taxpayers.²⁰ Commonly referred to as the “AMT patch,” this change will provide AMT relief to an estimated 18.4 million taxpayers and cost an estimated \$60 billion.

The act also allows taxpayers to offset nonrefundable personal tax credits against AMT for 2008²¹ and allows five-year modified accelerated cost recovery system life for farm machinery for both regular tax and AMT for 2009 only.²²

The Housing Assistance Tax Act allows taxpayers to offset low-income housing credits and housing rehabilitation credits against the AMT²³ to (in the words of the Senate Finance Committee staff summary of the act) “eliminate costs imposed on housing programs by the alternative minimum tax.”

In a Tax Court decision, a taxpayer’s invention of a side calculation for qualifying dividends to limit the tax rate to 15% and avoid a higher effective rate as a result of AMT was not allowed.²⁴

Sec. 56: Adjustments in Computing AMT

The Emergency Economic Stabilization Act allows 100% of net operating losses attributable to federally declared disaster areas in addition to the AMT net operating loss (NOL) for tax years beginning after December 31, 2007. The act also allows an AMT deduction for expenses to remediate a “qualified contamination site” per Sec. 198 (commonly known as “brownfield” remediation costs).

Case law: In 2000, a taxpayer exercised ISOs, some of which related to shares that were not vested. He made a Sec. 83(b) election to report AMT income for the nonvested shares, and he owed the AMT for 2000. In 2001, he lost his job and forfeited his nonvested shares; an AMT capital loss of \$680,000 resulted. In 2002, the taxpayer sold his vested shares for a regular tax capital gain of \$60,000 and an AMT capital loss of over \$2.5 million. He

deducted these losses for AMT purposes as net operating losses. The Ninth Circuit denied NOL treatment for AMT,²⁵ as had the Fifth Circuit in 2007.²⁶

*Norman*²⁷ and *Palahnuk*²⁸ involve nearly the same facts, except that these taxpayers did not have nonvested shares. The courts denied NOL treatment for AMT in these cases also. *Palahnuk* concludes that unless explicitly stated otherwise, all provisions that apply in calculating regular income tax also apply in calculating AMT. In 2008, the Federal Circuit reached the same conclusion.²⁹

Sec. 57: Items of Tax Preference

Under the Housing Assistance Tax Act, interest on certain tax exempt housing bonds will not be subject to AMT for housing bonds issued after July 30, 2008.³⁰

Sec. 62: Adjusted Gross Income

Sec. 62(a)(2)(D) allows eligible educators to deduct up to \$250 above the line for certain K–12 expenses. This deduction was extended to 2008 and 2009 by the Tax Extenders Act.

Sec. 63: Taxable Income Defined

Standard deduction: For 2008, the standard deduction amounts are as shown in Exhibit 1.³¹

Real property tax deduction: The Housing Assistance Tax Act created an additional standard deduction for 2008 for real property taxes equal to the lesser of the amount allowable under Sec. 164(a)(1) or \$500 (\$1,000 for married taxpayers filing jointly).³² The Tax Extenders Act extended this deduction to 2009.

Disaster loss deduction: A disaster loss deduction was added as an above-the-line deduction at Secs. 63(c)(1)(D) and (c)(8). This deduction applies to the “net disaster loss” defined at Sec. 165(h)(3)(B). Net

18 Sec. 53(e)(2).

19 Sec. 56(b)(3).

20 Sec. 55(d)(1).

21 Sec. 26(a).

22 Sec. 168(e)(3)(B).

23 Sec. 38(c)(4)(B).

24 *Weiss*, 129 T.C. 175 (2007).

25 *Kadillak*, No. 07-70600 (9th Cir. 7/29/08), aff’g 127 T.C. 184 (2006).

26 *Merlo*, 492 F.3d 618 (5th Cir. 2007).

27 *Norman*, No. 06-16741 (9th Cir. 7/29/08), aff’g No. CV-05-02059-RMW (N.D. Cal. 7/19/06).

28 *Palahnuk*, No. 07-0770-ag (2d Cir. 9/29/08), aff’g 127 T.C. 118 (2006).

29 *Pierce*, 274 F. App’x 897 (Fed. Cir. 2008).

30 Sec. 57(a)(5)(C)(iii).

31 Rev. Proc. 2007-66, §3.11.

32 Secs. 63(c)(1)(C) and (c)(7).

disaster loss is the “excess of (i) the personal casualty losses — (I) attributable to a federally declared disaster occurring before January 1, 2010, and (II) occurring in a disaster area, over (ii) personal casualty gains.”

Sec. 165(h)(3)(C)(i) defines a federally declared disaster as one that is subsequently determined by the president to require government assistance. Sec. 165(h)(3)(C)(ii) defines disaster area as the “area so determined to warrant such assistance.”

Sec. 68: Overall Limitation on Itemized Deductions

For 2008, the “applicable amount” of AGI above which the amount of otherwise allowable itemized deductions is reduced is \$159,950 (or \$79,975 for a separate return filed by a married individual).³³

Sec. 71: Alimony and Separate Maintenance Payments

A recent district court case dealt with the issue of defining alimony.³⁴ In the case, married taxpayers separated in November 1992. In 1993, the husband gave his paychecks to the wife, which she deposited and used to pay bills. No specific records were kept by either, and the husband estimated the amount he paid was about \$70,000. In October 1993, a state order noted there would be no payment of support or alimony at such time.

The couple were officially divorced in March 1994. In June 1994, a state order was made noting that the 1993 payments were family support that the wife should include in income and the husband could deduct. On his 1993 return, the husband claimed an alimony deduction of \$70,963. The IRS disallowed it. The wife said she could not remember what she reported on her 1993 return.

In May 2007, the husband filed a complaint in court seeking a refund for 1993. The husband argued that the \$70,000 was taxed twice even if the wife erroneously failed to include it in her 1993 return.

The district court held that it could not be proved that the amounts were paid and noted that the husband “cannot prove that

such payment was made ‘under’ a divorce or separation agreement because he deposited his paychecks into the joint banking account nearly a year before the execution of the Settlement Agreement or its incorporation into a judgment by the California state court.”

The court also noted that other courts have held that (1) “payments made before the existence of a written divorce or separation instrument are not deductible by the payor spouse under section 215” and (2) the “retroactive deeming of payments as family support by state courts does not meet the requirements of section 71(b)(1)(A).”

Finally, the court did not support the double taxation argument because the husband (1) could not prove that the wife had reported the \$70,000 as income and (2) could not point to any law that states that double taxation of the income entitles the husband to equitable relief.

Sec. 72: Annuities

The Heroes Earnings Assistance and Relief Act makes permanent the penalty exception for “qualified reservist distributions” that was added at Sec. 72(t)(2)(G)(iv) by the Pension Protection Act of 2006,³⁵ so that individuals ordered or called to active duty after September 11, 2001, are not subject to the 10% early withdrawal penalty on distributions from retirement plans. The Heroes Act change is effective for individuals ordered or called to active duty on or after December 31, 2007.

Sec. 83: Property Transferred in Connection with Performance of Services

A district court case dealt with the proper recognition of income from the exercise of stock options.³⁶ In 1998, a taxpayer was granted stock options with an exercise price of \$15 per share. In early 2000, the stock price was over \$1,000 per share. Between September 1999 and July 2000, the taxpayer exercised her stock options on various dates.

On her 1999 return, the taxpayer reported as gross income the excess of the market value of the stock on the exercise

dates over the option price. The taxpayer did not report any spread income for 2000. However, the taxpayer’s employer withheld Medicare tax from the taxpayer’s 1999 and 2000 wages measured as if she had recognized income from exercising options in both years. The taxpayer sought a refund of income and Medicare taxes, arguing that no income was reportable because the stock was not transferable and was subject to a substantial risk of forfeiture until January 2001.

Per Sec. 83 and Regs. Sec. 1.83-7, the receipt of stock is not taxable when received if it is not transferable or if it is subject to a substantial risk of forfeiture. Instead, it becomes taxable in the year in which it becomes transferable or is no longer subject to risk of forfeiture. These rules also hold that if sale of the stock could make the seller liable under §16(b) of the Securities Exchange Act of 1934, it is not transferable and is subject to substantial risk of forfeiture. Compliance with §16(b) generally requires that stock be held for six months prior to sale. The SEC rules provide that acquiring an option is a “purchase” under §16(b) rather than the exercise of the option.

The taxpayer argued that the SEC rule applied only if the stock was vested. The court stated that “[b]ased on the legal landscape as it existed in 2000, the Court finds that [the taxpayer] could have been subjected to suit under §16(b).” Thus, the court ruled that the taxpayer was not required to report any income until six months after the last vesting date, which was December 2000.

The taxpayer next argued that pooling-of-interest rules for GAAP posed a substantial risk of forfeiture allowing deferral of the income to 2001. The court disagreed. Thus, the income should have been reported in 2000, rather than 1999.

Sec. 108: Income from Discharge of Indebtedness

The exclusion from gross income of discharge of principal residence indebtedness has been extended to January 1, 2013.³⁷

³³ Sec. 68(b).

³⁴ *Rafferty*, No. 07-cv-00903-EWN-BNB (D.C. Colo. 7/8/08).

³⁵ Pension Protection Act of 2006, P.L. 109-280.

³⁶ *Strom*, No. C06-0802RSL (W.D. Wash. 10/6/08).

³⁷ Sec. 108(a)(1)(E).

The Mortgage Forgiveness Debt Relief Act of 2007³⁸ previously added the provision whereby qualified principal residence indebtedness, not in excess of \$2 million (\$1 million for single filers), that is discharged is excluded from gross income. This exclusion takes precedence over the insolvency exclusion, unless elected otherwise. The basis of the taxpayer's home is reduced by the amount of the discharged debt. The exclusion does not include debt discharged in exchange for services rendered.

The exclusion applies only to acquisition debt on a principal residence as defined in Sec. 121.³⁹ Thus, second homes and rental property are excluded.

Qualified principal residence indebtedness is acquisition indebtedness as defined in Sec. 163(h)(3)(B), with a \$2 million limit instead of a \$1 million limit. It includes debt for the acquisition, construction, and/or improvement of the home. It also includes a second mortgage or home equity line of credit on the home as long as the loan proceeds are used for acquisition/construction or home improvement.

The discharge can be in full (foreclosure) or in part (loan rewrite). In the case of a partial discharge, the tax benefit may be lost in part or in full. This occurs if the taxpayers subsequently sell the reduced-basis home, realizing a larger gain. To the extent a gain is realized, it may be excluded to the maximum of \$250,000 (\$500,000 married filing jointly).⁴⁰

Some restrictions apply: Discharges resulting from the performance of services for the lender do not qualify for income exclusion. Similarly, the income exclusion is not available for conditions not related to declines in the property value or the taxpayers' financial condition.⁴¹ An ordering rule is imposed such that the discharge is reduced by any amount that is not qualified principal residence indebtedness.⁴²

Sec. 121: Exclusion of Gain from Sale of Principal Residence

Partial gain exclusion: Gain on the sale of a principal residence after December 31, 2008, cannot be excluded from income for periods of nonqualified use. Taxpayers will have to determine the amount of gain based on the ratio that the aggregate periods of nonqualified use bear to the period the taxpayer owned the property. No period of use before January 1, 2009, will be considered nonqualified (the numerator); however, use before January 1, 2009, will be included in the period of total ownership (the denominator). In addition, no period of use after the property was used as a principal residence is taken into account in determining periods of nonqualified use.

There are exceptions for military service, health problems, change of employment, or other unforeseen circumstances.⁴³

This provision will reduce the amount of gain that taxpayers can exclude when they move into what had been their second home or a former rental property. The provision is applied after the depreciation recapture rules and without regard to any gain resulting from the recapture rules.

Surviving spouses: An unmarried individual whose spouse is deceased (surviving spouse) can exclude \$500,000 of capital gain as long as he or she sells the home within two years of the spouse's death.⁴⁴ The decedent and the surviving spouse must have owned and lived in the house two of the five years prior to the decedent's death.⁴⁵ The exclusion amount applies to sales or exchanges after December 31, 2007.

Intelligence community: The Heroes Earning Assistance and Relief Act makes permanent the ten-year suspension of the Sec. 121 five-year testing period for certain employees of the intelligence community when they sell their principal residences.⁴⁶

Sec. 134: Certain Military Benefits

The Heroes Earning Assistance and Relief Act provides various benefits for military personnel. The act allows an exclusion from gross income for bonus payments made by a state or political subdivision to current or former members of the uniformed services (or dependents) for service in a combat zone.⁴⁷

Sec. 139B: Benefits Provided to Volunteer Firefighters and Emergency Medical Responders

New for 2008 are two benefits to members of qualified volunteer emergency response organizations (volunteer firefighters and emergency medical responders).⁴⁸ First, members can exclude qualified state and local tax benefits (reduction or rebate of tax) from gross income.⁴⁹ These include benefits for state and local real property, personal property, and income taxes.⁵⁰ Double benefits (i.e., a Sec. 139B income exclusion and a state and local tax itemized deduction) are prohibited.⁵¹

Second, qualified payment (including reimbursement) for services as an emergency volunteer is excluded from gross income.⁵² For example, mileage reimbursement could be excluded. However, double benefits of the exclusion and a charitable (mileage) itemized deduction are prohibited.⁵³

The qualified payment exclusion maximum is \$30 per month of service (maximum \$360 annually).⁵⁴ The new Code section applies to tax years beginning after December 31, 2007, and before January 1, 2011.⁵⁵

Sec. 151: Allowance of Deduction for Personal Exemptions

The personal exemption amount is \$3,500 for 2008. The personal exemption amount begins to phase out at, and reaches the

38 Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142.

39 Secs. 121 and 108(h)(5).

40 Sec. 121.

41 Sec. 108(h)(3).

42 Sec. 108(h)(4).

43 Sec. 121(b)(4)(C)(ii).

44 Sec. 121(b)(4).

45 Secs. 121(a), (b)(2)(A)(i), and (ii).

46 Sec. 121(d)(9)(A).

47 Sec. 134(b)(6).

48 Sec. 139B(c)(3).

49 Sec. 139B(a)(1).

50 Secs. 139B(c)(1) and 164(a)(1), (2), and (3).

51 Sec. 139B(b)(1).

52 Sec. 139B(a)(2).

53 Secs. 139B(b)(2) and 170(i).

54 Sec. 139B(c)(2).

55 Sec. 139B(d).

Exhibit 2: Personal exemption phaseout

Filing status	AGI beginning of phaseout	AGI maximum phaseout
Married individuals filing joint returns and surviving spouses	\$239,950	\$362,450
Heads of households	199,950	322,450
Unmarried individuals (other than surviving spouses and heads of households)	159,950	282,450
Married individuals filing separate returns	119,975	181,225

maximum phaseout amount after, the AGI amounts shown in Exhibit 2.⁵⁶

Sec. 152: Dependent Defined

Final regulations, effective for tax years beginning after July 2, 2008, clarify the rights of divorced, separated, or never-married parents to claim the dependency exemption under Sec. 152(e).⁵⁷ The final regulations are close to the proposed regulations issued in May 2007,⁵⁸ but they adopt a number of the recommendations made by organizations including the AICPA and the ABA Tax Section. Issues addressed include the definition of custodial parent, the requirements for release of the right to claim a child, the revocation of a release of that claim, and the effect of these rules on never-married parents. Examples clarify the “counting nights” rule, the proper form of original release of the exemption, and subsequent revocation of that release.

For tax years beginning after December 31, 2004, Sec. 152(e) includes no general rule allowing the custodial parent to claim an exemption for a child. It provides that a child is treated as the qualifying child or qualifying relative of the noncustodial parent if:

1. The parents are divorced, legally separated, or live apart during the last six months of the tax year;
2. The child receives over one-half of the child’s support during the calendar year from one or both parents;
3. The child is in the custody of one or both parents for more than one-half of the calendar year; and
4. The custodial parent releases the claim to the exemption.

Thus, under current Sec. 152(e), the custodial parent’s release of the claim is not an exception to a general rule but is a condition precedent to the application of Sec. 152(e). The proposed regulations include an example illustrating that Sec. 152(e) does not apply if the custodial parent does not release the claim, in which case entitlement to the exemption is determined under Sec. 152(c) or (d).

Commentators suggested that the final regulations should reverse the conclusion of this example. The commentators opined that the final regulations should interpret Sec. 152(e) as if it included the general rule from before the enactment of the Working Families Tax Relief Act and provide that the custodial parent is entitled to the exemption if the custodial parent does not release the claim. The IRS did not adopt this suggestion because it is inconsistent with the language of Sec. 152(e) as amended by the Working Families Tax Relief Act.

The Fostering Connections to Success and Increasing Adoptions Act clarifies the uniform definition of a child by requiring that (1) the child must be younger than the taxpayer claiming the child and (2) the child must be unmarried. An additional paragraph is added to Sec. 152(c)(4) that allows a taxpayer other than a parent to claim a qualifying child if no parent claims the child and the taxpayer has an AGI higher than any parent of the child.

Sec. 162: Trade or Business Expenses

Executive compensation: The Emergency Economic Stabilization Act caps

the executive compensation deduction at \$500,000 for employers selling more than \$300 million of troubled assets in the Troubled Assets Relief Program (TARP), effective for tax years ending after October 3, 2008.⁵⁹ Notice 2008-94⁶⁰ provides guidance in question-and-answer format concerning the changes to Sec. 162(m).

Substantiation: In a Tax Court decision, a sales representative with a territory in several states was allowed to take the standard mileage deduction even though he did not keep contemporaneous records.⁶¹ He recorded his trips and mileage every day on small hand-held mileage logs, transferred this information to weekly “rough charts,” and then prepared monthly mileage logs, the only paperwork presented at the trial. The taxpayer prepared his own tax return. The court commented that it was “impressed with his attempt to comply with the substantiation requirements of section 274(d)” as he was not a sophisticated taxpayer.

Sec. 163: Interest

Investment property interest: In Rev. Rul. 2008-38,⁶² which amplifies Rev. Rul. 2008-12,⁶³ the IRS ruled that in the case of an individual limited partner, interest paid or accrued on indebtedness allocable to property held for investment described in Sec. 163(d)(5)(A)(ii) is a trade or business deduction that is deductible to the extent allowable after the application of the Sec. 163(d)(1) limitation. The interest paid or accrued is taken into account in determining the individual’s AGI and does not constitute an itemized deduction.

Where the individual limited partner has both investment interest expense attributable to indebtedness allocable to property held as a passive activity and investment interest expense attributable to indebtedness allocable to property held in an activity involving the conduct of a trade or business, and his or her aggregate investment interest expense is greater than the net investment income, the taxpayer must allocate his or her net investment

⁵⁶ Rev. Proc. 2007-66, §3.19.

⁵⁷ T.D. 9408.

⁵⁸ REG-149856-03.

⁵⁹ Sec. 162(m)(5).

⁶⁰ Notice 2008-94, 2008-44 I.R.B. 1070.

⁶¹ *Larson*, T.C. Memo. 2008-187.

⁶² Rev. Rul. 2008-38, 2008-31 I.R.B. 249.

⁶³ Rev. Rul. 2008-12, 2008-10 I.R.B. 520.

income between the two categories using a reasonable method of allocation.

Investment income election: A series of letter rulings present various circumstances under which the Service granted an extension of time to make an election to treat qualified dividend income or capital gain income as investment income under Secs. 163(d)(1) and (d)(4)(B). One ruling also dealt with the revocation of earlier elections under Sec. 163(d)(1).⁶⁴

Estate tax interest: In a legal memorandum dated May 12, 2008, the Service ruled that interest on estate tax accrued during the extension period for paying tax under Sec. 6161 is nondeductible personal interest under Sec. 163(h)(2).⁶⁵

Qualified mortgage insurance: Under Sec. 163(h)(3)(E), premiums a taxpayer pays for qualified mortgage insurance on a mortgage secured by his or her principal residence are deductible as qualified residence interest. The deduction is reduced by a 10% phaseout per \$1,000 of income (\$500 married filing separately) in excess of \$100,000 (\$50,000 married filing separately).⁶⁶

The treatment of mortgage insurance premiums as deductible mortgage interest has been extended to December 31, 2010.⁶⁷ This applies to amounts paid or accrued after December 31, 2007, but does not apply to mortgage insurance contracts issued before January 1, 2007.

Sec. 164: Taxes

The Tax Extenders Act extends the election to deduct state and local sales taxes to years 2008 and 2009.⁶⁸

Sec. 165: Losses

Hurricane grants: Notice 2008-95⁶⁹ provides the procedures to follow if an individual received a grant under P.L. 109-148, 109-234, or 110-115 for damage to a principal residence (per Sec. 121) caused by Hurricanes Katrina, Rita, or Wilma and would prefer to amend the prior return in

which the casualty loss was claimed rather than apply the Sec. 111 tax benefit rule and report the grant in the year received.

The amended return must be filed by the later of (1) the due date for filing the return for the year the grant was received or (2) July 30, 2009. If the amended return approach is used, there is no penalty or interest on the resulting tax underpayment, provided it is paid no later than one year after filing the amended return. If the amended return is filed before July 30, 2009, the IRS will treat it as filed on that day for the purpose of determining the one-year payment period when interest and penalties are waived.



Amended returns filed under this procedure are to be sent to the Austin IRS campus. The Form 1040X, Amended U.S. Individual Income Tax Return, should note at the top in dark, bold letters: "Hurricane Grant Relief." See the notice for additional filing details.

Federally declared disasters: The Emergency Economic Stabilization Act contains many disaster relief provisions and creates a new definition for "federally declared

disasters." A federally declared disaster is "any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act."⁷⁰

The 10%-of-AGI limit on personal casualty losses is waived for federally declared disasters in 2008 and 2009.⁷¹ This means that an eligible individual's losses are allowed to the extent of the sum of: (1) the amount of the personal casualty gains for the tax year, plus (2) the net disaster loss, plus (3) as much of the excess of personal casualty losses over personal casualty gains (reduced by the net disaster loss) as exceeds 10% of the individual's AGI. Personal casualty gains are recognized gains from the involuntary conversion of property arising from a casualty. Net disaster losses equal the excess of personal casualty losses attributable to a federally declared disaster occurring before January 1, 2010, in a disaster area over personal casualty gains.

The act allows taxpayers who do not itemize to take an additional standard deduction for losses from federally declared disasters.⁷² This deduction applies for both regular tax and AMT. The added deduction equals the excess of the taxpayer's personal casualty losses attributable to a federally declared disaster over the taxpayer's personal casualty gains.

Taxpayers are allowed to carry back "qualified disaster losses" (as defined in Sec. 172(j)(1)(A)) for five years and deduct them for AMT purposes.

The 50% bonus depreciation and AMT depreciation relief are allowed for federally declared disasters that occur after 2007 and before 2010.⁷³

Sec. 166: Bad Debts

In a Tenth Circuit case,⁷⁴ the taxpayer was a co-founder and major stockholder in a company to which he made a loan. The company filed for bankruptcy, and the

64 IRS Letter Rulings 200841008 (10/10/08), 200836006 (9/5/08), and 200836008 (9/5/08).

65 Chief Counsel Advice 200836027 (9/5/08).

66 Sec. 163(h)(3)(E)(ii).

67 Sec. 163(h)(3)(E)(iv)(I).

68 Sec. 164(b)(5)(I).

69 Notice 2008-95, 2008-44 I.R.B. 1076.

70 Sec. 165(h)(3)(C)(i).

71 Sec. 165(h)(3)(A).

72 Sec. 63(c)(1)(D).

73 Sec. 168(n).

74 *Rendall*, No. 06-9007 (10th Cir. 8/5/08), aff'g T.C. Memo. 2006-174.

taxpayer claimed a bad debt deduction for the loan. The company's stock was trading at \$3 a share. The court upheld the Tax Court's denial of a deduction because the taxpayer did not demonstrate that there was no reasonable hope of being paid.

Sec. 170: Charitable Contributions and Gifts

Direct transfers from IRAs: The Tax Extenders Act extends tax-free treatment of direct transfers from IRAs to charitable organizations by persons aged 70½ and older to the years 2008 and 2009.⁷⁵

Midwestern disaster areas: The Tax Extenders Act also temporarily suspends limitations on charitable deductions to the midwestern disaster area, effective for contributions beginning on the earliest applicable disaster date for all states and ending on December 31, 2008.⁷⁶ It increases the charitable standard mileage rate for midwestern-related relief to 70% of the business mileage rate beginning on the applicable disaster date and ending on December 31, 2008.

Valuation: In a Tax Court case, the taxpayers were doctors and shareholders in a medical professional service corporation.⁷⁷ They provided services to patients at Oregon Health and Science University Hospital (OHSU). OHSU's management concluded that all medical practice specialty groups would be consolidated into one medical practice group, OHSUMG, a Sec. 501(c)(3) organization.

Taxpayers donated their stock to OHSUMG, and all but two shareholders deducted approximately \$402 per share. However, OHSUMG did not expect to derive any economic benefit from the stock and accepted the donation as a professional courtesy.

The IRS's expert viewed the corporation as not being a going concern because of the impending consolidation and valued the stock at \$37 and \$35 per share for the voting and nonvoting shares, respectively. The expert determined the value of the

corporation's assets and liabilities and then applied a 35% discount for lack of control, a 45% discount for lack of marketability, and a further 5% discount to the nonvoting shares for lack of voting rights. The taxpayers had argued that the consolidation would not necessarily occur.

The court valued the shares in accordance with the IRS's expert and imposed a 40% undervaluation penalty, except in situations in which the total understatement did not exceed \$5,000. The litigating shareholders escaping that penalty were liable for the negligence penalty.

Sec. 172: Net Operating Loss Deduction

The Tax Extenders Act extends the NOL carryback period from two to five years for midwestern disaster area losses incurred on or after the applicable disaster date and before 2011.⁷⁸

Sec. 179: Election to Expense Certain Depreciable Business Assets

The Tax Extenders Act increases the Sec. 179 expensing amount by up to \$100,000 (and increases the beginning of the phase-out amount) for qualified disaster assistance property, effective for property placed in service after 2007 for disasters declared after 2007.⁷⁹

Sec. 183: Activities Not Engaged in for Profit

In a Tax Court case, the taxpayer claimed to be in the trade or business of gambling and filed a Schedule C showing a loss from this activity.⁸⁰ He kept no business records, but depended on the amount of activity recorded on his casino-issued Players Club card. He further claimed that the Players Club points he accumulated and redeemed proved that he engaged in the activity for profit.

The IRS issued a deficiency notice and determined that the taxpayer's winnings were includible in gross income, and he

could only deduct his losses (up to the extent of his winnings) on Schedule A, Itemized Deductions.

The Tax Court determined that:

1. Even if the taxpayer engaged in gambling as a trade or business, Sec. 165(d) allows losses only to the extent of gains.
2. It is the taxpayer's responsibility to maintain books or records; he cannot depend on the casino to do so. Even though the Tax Court has accepted a Players Club card statement as a record of wins and losses,⁸¹ the taxpayer still must provide other evidence of activity not recorded by the card.
3. The taxpayer claimed to have played over 1,100 hours during the year, but the Players Club card recorded only 319 hours of play. The taxpayer provided no other records to substantiate his playing time. He also admitted to not checking that the card was recording all his playing time.

The court concluded that if the taxpayer wishes to include the value of "prizes" redeemed with his Players Club points to prove a profit motive, he must include their value in income. He did not. The court also felt that these prizes were more in the nature of goods purchased using some of the amounts spent on wagering.

In three other cases, the IRS determined deficiencies, finding that the taxpayers were not engaged in a trade or business, and denied losses from the activity in question. All three involved breeding activities (two of show horses and one of racing greyhounds).

In *Miller*,⁸² the Tax Court found for the taxpayer and allowed the losses. In *Whitecavage*⁸³ and *Keating*,⁸⁴ the court agreed with the IRS's determination. In applying the factors listed in Regs. Sec. 1.183-2(b), some clear differences existed among the cases, resulting in the differing opinions.

1. In *Miller*, the taxpayer consulted with and hired established experts (trainers or vets) in the field. This was not so in the other two cases.

75 Sec. 408(d)(8).

76 Sec. 1400S.

77 *Bergquist*, 131 T.C. No. 2 (2008).

78 Sec. 1400N(k).

79 Sec. 179(e).

80 *Merkin*, T.C. Memo. 2008-146.

81 *Hardwick*, T.C. Memo. 2007-359, and *Lutz*, T.C. Memo. 2002-89.

82 *Miller*, T.C. Memo. 2008-224.

83 *Whitecavage*, T.C. Memo. 2008-203.

84 *Keating*, No. 07-3660 (8th Cir. 10/14/08), aff'g T.C. Memo. 2007-309.

2. In *Miller*, the taxpayer had an established record of starting, running, and building a business. In *Whitecavage* (IRS auditor) and *Keating* (emergency room physician), the taxpayer's other work experience was solely as an employee.
3. In *Miller*, the taxpayer suffered some of his losses due to extraordinary circumstances beyond his control. He also started showing a profit in year five of the activity (2006; the case involved the period 2002–2004). The court determined that the losses occurred during the startup phase. In the other two cases, no profits were ever made over a substantial number of years.
4. In *Whitecavage* and *Keating*, the court found substantial personal pleasure involved in the activity, while this was not so in *Miller*.

The IRS has released a fact sheet that attempts to explain in clear language the factors it considers in determining whether an activity is a hobby as opposed to a trade or business.⁸⁵ Providing a copy of it or a customized version to all clients planning to start a new activity might prove helpful.

Sec. 198A: Expensing of Qualified Disaster Expenses

Taxpayers may elect to deduct qualified disaster expenses in the year in which they are paid or incurred.⁸⁶ A qualified disaster expense is paid or incurred in connection with a trade or business for abatement or control of hazardous substances that were released on account of a federally declared disaster occurring before January 1, 2010; for the removal of debris from, or the demolition of structures on, real property that is business-related property damaged or destroyed as a result of a federally declared disaster occurring before that date; or for the repair of business-related property damaged as a result of a federally declared disaster occurring before that date that otherwise would have to be capitalized. Any deduction allowed under Sec. 198A is treated as a deduction for depreciation and the property as Sec. 1245 property

for purposes of applying Sec. 1245 to the deduction.

Sec. 213: Medical and Dental Expenses

Dependent expenses: In the situation of divorced or legally separated parents or parents living apart for the last half of the calendar year, a child will be treated as the dependent of both parents for purposes of deducting medical expenses, regardless of whether the custodial parent releases the claim to the exemption. The child must receive over half of his or her support from the parents, be in the custody of one or both for over half the year, and qualify as a “qualifying child” or “qualifying relative” of one of the parents. This treatment also applies for Secs. 105, 106, 132, 220, and 223.⁸⁷

S corporation 2% shareholders: Under Notice 2008-1,⁸⁸ a 2% shareholder is allowed an above-the-line deduction for accident and health insurance premiums paid under a plan that is “established by the S corporation.”

In order for the 2% shareholder to deduct the premiums on his or her individual return, the S corporation must include the premium payments on the employee's Form W-2 for the tax year in which it is paid, and the shareholder must report those wages as income on Form 1040, U.S. Individual Income Tax Return. In addition, the employee's earned income from the S corporation must exceed the cost of the premiums under the policy for the shareholder-employee and spouse or dependents, if applicable.

Sec. 222: Qualified Tuition and Related Expenses

The Emergency Economic Stabilization Act extends the above-the-line deduction for qualified higher education tuition and fees through December 31, 2009. The maximum deduction remains \$4,000 for single and married taxpayers filing jointly, with AGI not exceeding \$65,000 and \$130,000, respectively. For taxpayers

whose income exceeds those amounts but does not exceed \$80,000 and \$160,000, the maximum deduction is \$2,000.

Sec. 408: Individual Retirement Accounts

Taxpayers who are married and file jointly may each be able to deduct up to \$5,000 in IRA contributions (\$6,000 if age 50 or older at the end of the year). Such taxpayers may be able to take an IRA deduction if they were covered by a retirement plan and their 2008 modified AGI is less than \$63,000 (\$105,000 if married filing jointly or a qualifying widow(er)).

Taxpayers may be able to deduct up to an additional \$3,000 if they participated in a 401(k) plan and their employer was in bankruptcy in an earlier year.

Sec. 877A: Tax Responsibilities of Expatriation

The 2008 Heroes Act included a new mark-to-market regime for taxing gains of U.S. citizens and long-term U.S. permanent residents who expatriate on or after June 17, 2008.⁸⁹ All property of a covered expatriate will be treated as sold on the day before the expatriation at fair market value. Gains in excess of \$600,000, adjusted for inflation after 2008, are includible in income and are taxed.

A gift tax is imposed on U.S. citizens or residents who receive on or after the date of enactment qualifying gifts or bequests from an expatriated individual (or an individual who immediately before death was a covered expatriate).⁹⁰ There is also a 30% withholding tax on qualifying deferred compensation paid to a covered expatriate.⁹¹

Sec. 911: Citizens or Residents Living Abroad

For tax years beginning in 2008, the foreign earned income exclusion amount is \$87,600.⁹²

Sec. 1012: Basis of Property—Cost

Life insurance policy: The Court of Federal Claims, applying the open

85 IRS FS-2008-23, *Is Your Hobby a For-Profit Endeavor?* (June 2008).

86 Sec. 198A(a).

87 Rev. Proc. 2008-48, 2008-36 I.R.B. 586.

88 Notice 2008-1, 2008-2 I.R.B. 251.

89 Sec. 877A(a).

90 Sec. 2801.

91 Sec. 877A(d).

92 Sec. 911(b)(2)(D)(i); Rev. Proc. 2007-66, §3.30.

transaction doctrine, allowed a policyholder to use the basis in his life insurance policy to fully offset the proceeds from demutualization of the insurance company and thus to report no gain.⁹³

Securities: Under the Emergency Economic Stabilization Act, every broker that is required to file an information return reporting the gross proceeds of a security (Form 1099-B, Proceeds from Broker and Barter Exchange Transactions) will have to include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to the security is short term or long term. This generally will apply to securities acquired after 2010.⁹⁴

Sec. 1031: Exchange of Property Held for Productive Use or Investment

Exchange funds: The IRS has issued final regulations on how to treat income earned on property or cash set aside in a qualified escrow account, qualified trust, or similar account pending completion of a deferred like-kind exchange. The regulations generally treat such exchange funds as a demand loan from a taxpayer to an exchange facilitator such as a qualified intermediary, unless all earnings attributable to the taxpayer's exchange funds are paid to him or her under the terms of the agreement.⁹⁵

Exchange property: The IRS has advised that it will allow the use of one property to engineer both a completed reverse like-kind exchange and an attempted forward like-kind exchange where the value of the relinquished property far exceeds the value of the replacement property received. The Service acknowledged that Sec. 1031, the regulations, and Rev. Proc. 2002-37⁹⁶ do not expressly allow the use of the same relinquished property in both a reverse exchange and a forward deferred exchange but determined that they also do not prohibit such use.⁹⁷

Improvements to replacement property: An exchange will not fail to qualify for nonrecognition of gain or loss under Sec. 1031 merely because the owner of the replacement property is, at the taxpayer's direction, constructing improvements to the replacement property at the time such property is identified as replacement property (leasehold interest).⁹⁸

Undivided fractional interests: An undivided fractional interest in properties owned via a tenants-in-common agreement by various related companies was deemed not to be a transfer of interest in a business entity.⁹⁹

Sec. 1058: Transfers of Securities Under Certain Agreements

Financial institutions often lend securities they own to broker dealers. Under these arrangements, the financial institution will hold collateral from the broker dealer at least equal to the value of the lent securities. If the broker dealer defaults on the loan, the financial institution will use the collateral to buy replacement securities. In the midst of the current financial crisis, the question has been raised of whether a broker dealer's default under a securities lending arrangement would be covered by Sec. 1058 or would instead be treated as a recognition event.

The IRS released a revenue procedure that concludes that no gain or loss will be recognized under Sec. 1058(a) if a lender of securities timely purchases replacement securities after the borrower defaults on the agreement because of the borrower's bankruptcy.¹⁰⁰

Sec. 1221: Capital Asset Defined

Under the Emergency Economic Stabilization Act, for sales or exchanges after December 31, 2007, in tax years ending after that date, applicable financial institutions may treat their losses on Fannie Mae and Freddie Mac preferred stock as ordinary losses as opposed to capital loss under Sec. 1221.¹⁰¹

Sec. 1250: Gain from Dispositions of Certain Depreciable Realty

The Emergency Economic Stabilization Act extends the 15-year write-off provision for qualified leasehold improvement property or qualified restaurant property for two years; therefore, it applies for such property placed in service through December 31, 2009.¹⁰²

Sec. 6428: 2008 Recovery Rebates for Individuals

Advance tax credits for tax year 2008—in the form of economic recovery rebate checks—were sent to individuals other than nonresident aliens, dependents, and estates or trusts.¹⁰³ Most taxpayers who qualify received between \$300 and \$600 (between \$600 and \$1,200 for married couples). The IRS calculated the rebate based on the taxpayer's 2007 tax return. However, a reconciliation process with the actual 2008 return is required, which may result in an additional benefit in 2009 (see below).

Taxpayers had to meet a qualifying income or net tax liability threshold to be eligible for the rebate.¹⁰⁴ Qualifying income had to be at least \$3,000 from the following sources: earned income, including combat pay and taxable self-employment income; Social Security benefits for retirement, disability, or survivors' benefits; or amounts received from veterans' affairs for disability compensation, disability pension, or survivors' benefits (under 38 U.S.C. chapters 11, 13, or 15).¹⁰⁵

The maximum rebate is the lesser of the tax liability or \$600 (\$1,200 for a joint return).¹⁰⁶ The minimum rebate is \$300 (\$600 for a joint return) as long as the taxpayer satisfies the *de minimis* requirements under Sec. 6428(b)(2)(A) or (B).

Taxpayers' rebates were increased by \$300 per qualifying child.¹⁰⁷ For example, a married couple with two qualifying children would have a maximum rebate of \$1,800 (\$1,200 primary plus \$600 for two

93 *Fisher*, No. 04-1726-T (Fed. Cl. 8/6/08).

94 Sec. 6045(g).

95 T.D. 9413.

96 Rev. Proc. 2002-37, 2002-1 C.B. 1030.

97 Chief Counsel Advice 200836024 (9/5/08).

98 IRS Letter Ruling 200842019 (10/17/08).

99 IRS Letter Rulings 200826005 (6/27/08), 200829012 (7/18/08), and 200829013 (7/18/08).

100 Rev. Proc. 2008-63, 2008-42 I.R.B. 946. See Levy, "Lenders Allowed

Nonrecognition Treatment for Certain Securities Loans Terminated Due to Bankruptcy," Tax Clinic, p. 15.

101 Emergency Economic Stabilization Act, §301.

102 Sec. 168(e)(7).

103 Sec. 6428(e)(3).

104 Sec. 6428(b)(2).

105 Sec. 6428(e)(1).

106 Sec. 6428(a).

107 Sec. 6428(b)(1).

child credits) and a minimum rebate of \$1,200 (\$600 primary plus \$600 for two child credits).

However, the total rebate phases out based on the taxpayer's AGI. The rebate is reduced by 5% of AGI in excess of \$75,000 (\$150,000 for a joint return).¹⁰⁸ The \$1,800 maximum credit for the married couple with two qualifying children would be reduced to zero at an AGI of \$186,000 ($\$186,000 - \$150,000 = \$36,000 \times .05 = \$1,800$).

To be eligible for a check, the taxpayer must have filed a 2007 return by October 15, 2008. No rebates were paid after December 31, 2008.¹⁰⁹

For 2008 returns, taxpayers will calculate the Sec. 6428 credit based on their actual 2008 information. If the allowable credit exceeds the rebate received in 2008, the taxpayer may use the excess credit against the 2008 tax liability.¹¹⁰ Taxpayers with a 2007 tax liability that falls between

the rebate's minimum and maximum amounts could receive an additional benefit. Taxpayers who had a child after they filed their 2007 return may be eligible for an additional qualifying child credit.

If the 2008 rebate amount exceeds the allowable credit, the taxpayer will not have to recognize the excess as taxable income (i.e., the taxpayer received a refundable tax credit via the 2008 rebate).

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EditorNotes

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108 Sec. 6428(d).

110 Sec. 6428(f).

109 Sec. 6428(g)(3).

Questions to Include in Individual Tax Organizers

By Eileen Reichenberg Sherr, CPA, M. Tax., AICPA, Washington, DC, and Andrew M. Mattson, CPA, Mohler, Nixon & Williams, Campbell, CA

To help clients avoid possible penalties and sanctions, practitioners should ensure that the following questions are included in their customized tax software organizers for individual clients for the upcoming filing season.

Status as an Owner, Director, or Officer of a Foreign Corporation

- Do you own, directly or indirectly, more than 10% of a foreign corporation?
- Are you an officer or director of a foreign corporation?

Foreign Bank Accounts

- Did you have an interest in or signature or other authority over a financial account in a foreign country, such as a bank account, securities account, retirement account, or other financial account?
- If yes, did the aggregate amount in your foreign financial account(s) exceed \$10,000 at any time during the year?

Note: A "yes" answer to either of the foreign corporation questions may indicate a requirement to file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. Indirect ownership exists when, for instance, an individual owns 10% or more of a U.S. company that owns 100% of a foreign subsidiary. A Form 5471 must be filed in such a case. The IRS has announced that starting January 1, 2009, it will send automatic \$10,000 penalty letters for late or inaccurate Forms 5471 attached to Forms 1120, U.S. Corporation Income Tax Return. (For more on this, see Keenan and Patel, "IRS Changes Policy for Asserting Penalties for Late-Filed Form 5471," Tax Practice & Procedures, p. 52).

The Form 5471 filing requirement for an individual can be met by the U.S. company if the Form 5471 filed by the U.S. company discloses the U.S. shareholder's information on page 1, Section D; however, the individual must attach a statement to his or her Form 1040 stating that the Form 5471 is filed with the U.S. company's income tax return.

Note: Regarding foreign bank accounts, the form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, is required to be filed by U.S. citizens, residents, and certain nonresidents (including individuals, corporations, partnerships, trusts, or estates) who have a financial interest in or signature or other authority over any financial accounts (including bank, securities, mutual fund, or other types of financial accounts in a foreign country) if the aggregate value of such accounts exceeded \$10,000 at any time during 2008.

A preparer who has any indication that a client may have a foreign bank account should ask the client about the existence of such an account and document the conversation in order to comply with what the IRS has suggested is a requirement under Circular 230.