

## EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

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## EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

The \$700 billion [Emergency Economic Stabilization Act of 2008](#), more commonly known as the “bailout bill,” was passed by Congress but not until \$150 billion of tax incentives were added. The new law includes an AMT relief act, a disaster relief act, an alternative energy bill and the extender bill. The Emergency Economic Stabilization Act of 2008 was signed into law on October 3, 2008.

The pertinent sections of this bill, 49 of the 75 provisions, are below, coordinated with the Federal Tax Update manual.

### **Chapter 1: Individual & Employee**

#### **§24(a): Refundable Child Credit ([Emergency Economic Stabilization Act of 2008](#))**

Starting in 2009, a qualifying child for purposes of the child tax credit must also be the taxpayer's dependent. This restores the pre-2005 rule, under which the child credit was explicitly tied to the child's dependency exemption.

#### **§24(d): Refundable Child Credit ([Emergency Economic Stabilization Act of 2008](#))**

**The earned income formula has been modified** for the determination of the refundable child credit to apply to 15% of earned income in excess of \$8,500 for taxable years beginning in 2008. Without this change, the threshold would have been \$12,050.

## RESIDENTIAL ENERGY EFFICIENT PROPERTY §25

### **§25C: Credit in 2009 Only for Energy-efficient Improvements to a Personal Residence by a Homeowner ([Emergency Economic Stabilization Act of 2008](#); [Notice 2006-26](#))**

**Energy-efficient improvements.** During 2009, (these items must be placed in service after Dec. 31, 2008 and before Jan. 1, 2010)<sup>1</sup>, individuals can again, with numerous changes, make energy-conscious purchases that will provide tax benefits when filling out their tax returns. These 2009 changes expanding the credit include certain stoves that use renewable plant-derived fuel, asphalt roofs with appropriate cooling granules, clarification of the efficiency standards applicable to water heaters, and removal of geothermal heat pump property (which, instead, became qualified under the Residential Alternative Energy Credit rules).

To qualify, a component must meet or exceed the criteria established by the 2000 International Energy Conservation Code (including supplements) and must be installed in the taxpayer's main home in the United States. The credit is 10% of the cost of (1) energy-efficient improvements to existing homes plus 100% of the cost of (2) “qualified energy property” expenditures subject to definitions and restrictions listed below (§25C). The maximum credit for all taxable years is \$500 — no more than \$200 of the credit can be attributable to expenses for windows. The following items are eligible:

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<sup>1</sup> This credit was also available in 2006 and 2007, but not available in 2008.

- NEW: Asphalt roofs with appropriate cooling granules
- Insulation systems that reduce heat loss/gain
- Exterior windows (including skylights)
- Exterior doors
- Metal roofs (meeting applicable Energy Star requirements).

In addition, the law provides a credit for costs relating to residential energy property expenses. The following items are eligible:

- \$50 for each advanced main air circulating fan
- \$150 for each qualified natural gas, propane, or oil furnace or hot water heater
- \$300 for "energy efficient building property," which includes electric and central air conditioners. (The credit for geothermal heat pumps is now available only as a Residential Alternative Energy Credit of §25D, discussed later).
- NEW ITEM: If purchased in 2009, a \$300 credit for the purchase of a stove that burns biomass fuel to heat a principal residence located in the United States, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75%. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants), grasses, residues, and fibers.

**Note:** Set-back thermostats and ceiling fans are not included in §25C(c)'s definition of qualified energy efficiency improvements. In addition, most drywall and siding won't qualify ([Notice 2006-53](#)).

**Preparer Pointer:** Second homes and rental units do not qualify for the credit.

**§25D: Credit for Residential Energy Efficient Property Expanded, Modified and Extended Through 2016 ([Emergency Economic Stabilization Act of 2008](#))**

A personal nonrefundable tax credit (§25D) is available for the purchase of specific residential alternative energy equipment installed on or in connection with the taxpayer's residence (including a vacation home) located in the United States. The residential alternative energy credit has been expanded and extended through 2016. For tax years beginning after December 31, 2007, the residential alternative energy credit is 30% of the following expenditures made by the taxpayer and placed in service during the tax year:

1. solar electric property,
2. solar water heating property,
3. fuel cell property,
4. NEW in 2008: small wind energy property, and
5. NEW in 2008: geothermal heat pump property.

The credit for any fuel cell may not exceed \$500 for each 0.5 kilowatt of capacity.

**Solar electric property credit cap eliminated.** In 2007 and 2008, the maximum credit for each of the solar systems of property is \$2,000. Starting in 2009, there is no annual maximum credit amount for qualified solar expenditures made through 2016.

**Qualified small wind energy property.** The 30% residential alternative energy credit has been expanded to include expenditures for qualified small wind energy property for property placed in service during tax years 2008 through 2016. Qualified small wind energy property must use a wind turbine to generate electricity for a taxpayer's U.S. residence (§25D(d)(4)). There is a \$500 credit maximum for each half kilowatt of electric capacity generated by a wind turbine, not to exceed \$4,000 annually. Expenditures for the residential alternative energy credit will not also qualify for the \$45 wind facility credit.

**Qualified geothermal heat pump property.** The 30% residential alternative energy credit has been expanded to include expenditures for qualified geothermal heat pump property for property placed in service during tax years 2008 through 2016. There is an annual maximum credit of \$2,000 for geothermal heat pump property (§25D(b)(1)(D)).

**Use of credit against AMT.** The residential alternative energy credit may be offset against regular tax and AMT liabilities in 2008 (§26(a)(2)). Starting in 2009, the residential alternative energy credit can be offset against the excess of both regular tax and AMT liabilities over the sum of the credits for dependent care, the elderly and disabled, adoption, child tax, new home buyer credit, education expenses, saver's, and nonbusiness energy property (§25D(c)(1)).

**Credit carryforward.** Through 2008, if this credit exceeds both tax liabilities reduced by all other nonrefundable credits except this energy credit, the excess is carried forward to the next tax year and added to any residential alternative energy credit for that tax year (§25D(c)(2)(A)). Starting in 2009, if the energy credit exceeds the excess of both regular tax and AMT liabilities over the sum of the credits for dependent care, the elderly and disabled, adoption, child tax, new home buyer credit, education expenses, saver's, and nonbusiness energy property, the excess can be carried to the next tax year and added to any residential energy credit for that tax year (§25D(c)(2)(B)).

### **§30D: New Plug-In Electric Drive Vehicle Credit ([Emergency Economic Stabilization Act of 2008](#))**

**New credit on purchase of new Volt or Telsa.** A tax credit for new qualified plug-in electric drive motor vehicles (NQPEDMVs), such as the [Telsa](#) (San Jose, CA) and the Chevy Volt (General Motors), is available if purchased and placed in service in 2009 through 2014. The amount of the NQPEDMV's credit is \$2,500, plus \$417 for each kilowatt hour of traction battery capacity in excess of four kilowatt hours. This credit is available only to the original user and is available to both businesses and individuals. If the NQPEDMV credit is claimed, it becomes disqualified for the hybrid credit...no double dipping.

**Nonbusiness use credit.** For individually-used plug-in electric drive vehicles, but not for hybrid vehicles, the nonbusiness portion of that credit is treated as a nonrefundable personal credit effective for taxable years beginning after December 31, 2008, allowing the credit to also offset the alternative minimum tax. This is a significant difference from the hybrid credit (§30B) as the hybrid credit is limited to the excess of the regular tax liability over the alternative minimum tax liability.

**Business credit.** If the NQPEDMV is used by a business, and therefore subject to depreciation, the basis of any qualified vehicle is reduced by the amount of the credit. In addition, the credit allowed for the business use portion is treated as part of the general business credit; only the nonbusiness portion is allowed to calculate the new qualified plug-in electric drive vehicle credit.

### ALTERNATIVE MINIMUM TAX - §55

**§55: 2008 AMT Exemption & Phase-out Chart ([Emergency Economic Stabilization Act of 2008](#))**

|                         |                 | Before 2001 &<br>After 2008 | 2007                | 2008                       |
|-------------------------|-----------------|-----------------------------|---------------------|----------------------------|
| Unmarried               | Exemption amt:  | \$33,750                    | \$44,350            | <b>\$46,200</b>            |
|                         | Phaseout range: | \$112,500-\$247,500         | \$112,500-\$289,900 | <b>\$112,500-\$297,300</b> |
| Married filing<br>joint | Exemption amt:  | \$45,000                    | \$66,250            | <b>\$69,950</b>            |
|                         | Phaseout range: | \$150,000-\$330,000         | \$150,000-\$415,000 | <b>\$150,000-\$429,800</b> |

#### The Minimum Tax Credit

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

#### Examples of deferral preferences and adjustments:

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

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

#### §53: Refundable Minimum Tax Credit

Taxpayers who paid Alternative Minimum Tax in previous years and have been unable to use the Minimum Tax Credit in subsequent years, got a break in the Tax Relief and Health Care Act of 2006.

**Long term unused AMT credit.** Beginning in 2007, a minimum tax credit that was generated more than three years earlier (in 2004 or earlier for tax year 2008) is considered a “long-term unused minimum tax credit”. If the amount of this long-term credit was more than \$25,000, up to 20% of it was refundable in the current year. If the amount of the long-term credit was \$25,000 or less, the refundable credit was the lesser of \$5,000 or the actual amount of the credit. The Technical Corrections Act of 2007 ensured that once the 20% was established in the first year, at least that amount would be refundable in subsequent

years.

**AGI limits apply for 2007.** Certain high-income taxpayers had to wait to take advantage of this new credit. For individuals with 2007 adjusted gross income (AGI) over \$156,400 (\$234,600 for married filing joint) the amount of the refundable credit phased out at the rate of 2% for each \$2,500 (or fraction thereof) that the taxpayer's AGI exceeded the threshold. For singles with AGI over \$278,900 and marrieds filing joint with AGI over \$357,100 the credit was completely phased out.

**§53: NEW! Allowance of Long-term Unused Credits ([Emergency Economic Stabilization Act of 2008](#))**

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

**Example.** Eric exercised incentive stock options in 2001 and paid Alternative Minimum Tax in the amount of \$100,000 over the amount of his regular tax. His dot-com stock crashed, and he continues to hold the stock, hoping the value will rise someday. His other income each year totals \$100,000. Eric has been able to recover some of his credit each year, but only a total of \$9,500. Coming into 2007 he had a credit carryover of \$90,500. Eric received a refundable credit of \$18,100 ( $\$90,500 \times 20\%$ ) in 2007. Prior to the changes in the Emergency Economic Stabilization Act of 2008, he could expect that same credit over the next four years. Now, he will recover the remaining \$72,400 ( $\$90,500 - \$18,100$ ) over the next two years.

| Year | Prior-Law Refundable Credit | Credit Under New Law |
|------|-----------------------------|----------------------|
| 2007 | 18,100                      | 18,100               |
| 2008 | 18,100                      | 36,200               |
| 2009 | 18,100                      | 36,200               |
| 2010 | 18,100                      | 0                    |
| 2011 | 18,100                      | 0                    |

Moreover, if Eric's AGI was over \$278,900 in 2007, he would have received no credit. Beginning in 2008, he will begin to recover the credit over the next two years, regardless of his AGI.

**NEW! Tax Abatement - Yes, Really! - And a Refund of Penalties and Interest Paid ([Emergency Economic Stabilization Act of 2008](#))**

The Emergency Economic Stabilization Act of 2008 also provides that any underpayment of tax outstanding on the date of enactment which is attributable to the application of the minimum tax adjustment for incentive stock options (including any interest or penalty relating thereto) is abated. No

tax which is abated is taken into account in determining the minimum tax credit. This provision is effective October 3, 2008.

In addition, the Act provides that the AMT refundable credit amount and the AMT credit for each of the first two taxable years beginning after December 31, 2007, are increased by one-half of the amount of any interest and penalty paid before the date of enactment on account of the application of the minimum adjustment for incentive stock options.

**Example.** Suppose Eric, from the above example, has been unable to pay the \$100,000 additional tax from his 2001 return. He has been making installment payments, but so far has only paid down \$30,000. Effective October 3, 2008, the remaining \$70,000 is abated, and his minimum tax credit is reduced by that same \$70,000. However, to the extent some of his installments paid interest and penalties, one-half of all penalties and interest paid up to October 3, 2008 will be added to his minimum tax credit for 2008 and again in 2009.

## MISCELLANEOUS PROVISIONS

### **§62: \$250 “Above-the-Line” Deduction For Classroom Materials ([Emergency Economic Stabilization Act of 2008](#)); [§62\(a\)\(2\)\(D\)](#)**

**Deduction for educator expenses extended through the end of 2009.** Educators who work at least 900 hours during a school year as a teacher, instructor, counselor, principal, or aide, may deduct up to \$250 of qualified out-of-pocket expenses for books and classroom supplies. The deduction is available for those in public or private elementary or secondary schools (including kindergarten).

### **§63: NEW: Additional Standard Deduction for State and Local Real Property Taxes in 2008 and 2009 ([Emergency Economic Stabilization Act of 2008](#)); The Housing and Economic Recovery Act of 2008.**

An individual taxpayer's standard deduction for taxable years beginning in 2008 or 2009 is increased by the lesser of (1) the amount allowable to the taxpayer as a deduction for real estate taxes described in §164(a)(1), or (2) \$500 (\$1,000 in the case of a married individual filing jointly).

**Example.** Martha and George, who are both over 65, do not itemize their deductions. In 2008, they paid \$1,500 of real estate taxes on their home. Their 2008 standard deduction will be \$14,000 (\$10,900 for MFJ plus \$2,100 because both are 65 or older plus \$1,000 for real estate taxes).

### **Who benefits from the extra standard deduction for real estate taxes?**

1. Taxpayers with paid off mortgages, generally retired clients.
2. Taxpayers who buy their first house late in the year resulting in only a few months of mortgage interest expense. Thus standard deduction exceeds their itemized deductions.
3. Taxpayers buying a house in a low cost area where interest and taxes don't immediately push them far over the standard deduction. . . in other words, Montana homeowners.

**§151: Uniform Definition of “Qualifying Child” Modified, Tiebreaker Rules Clarified ([Emergency Economic Stabilization Act of 2008](#))**

**For an individual to be considered a “qualifying child”, five tests must be satisfied ([Emergency Economic Stabilization Act of 2008](#)):**

1. **Relationship.** The child is related to the taxpayer, such as:
  - a. a son, daughter, stepson, stepdaughter or a descendant of such child;
  - b. a brother, sister, stepbrother, stepsister or a descendant of such relative (§152(c)(2));
  - c. foster or adopted children. An eligible foster child is a child who is placed with the taxpayer by an authorized placement agency or by a decree issued by the courts. An eligible adopted child includes both a legally adopted child and a child legally placed for adoption (§152(f)(1)).
2. **New: Age.** The child must not have attained the age specified in the particular provision of the law requiring “qualified child” status. For example, to claim an exemption, the qualifying child must not have attained the age of 19 by the end of the calendar year or must be a student that has not attained the age of 24 by the end of the calendar year. To be a student, the individual must be attending, on a full-time basis for at least five calendar months in a year, a qualified educational institution or a qualified on-farm training program (§152(c)(3) and (f)(2)). **Starting in 2009, a qualifying child must be younger than the taxpayer (§152(c)(3)(A)). Therefore, a taxpayer's older brother or sister cannot be the taxpayer's qualifying child.** Exceptions to this requirement exist for any individual who is totally and permanently disabled at any time during the year.
3. **Principal place of abode.** The child must have the same principal place of abode as the taxpayer for more than one-half of the year (§152(c)(1)(B)).
4. **Support.** The child must not provide more than one-half of his or her own support for the year (§152(c)(1)(D)).
5. **New: Joint return restriction. Starting in 2009, the child must not have filed a joint return (other than only for a claim of refund) with a spouse for any tax year beginning in the calendar year in which the taxpayer's tax year begins (new: §152(d)(1)(E)).**

**Comment:** The new test #5 affects numerous tax benefits using the “qualifying child” definition, but not the dependent exemption as a dependent was prohibited from filing a return before this amendment (§152(b)(2)).

**New: Tie-breaking rules ([Emergency Economic Stabilization Act of 2008](#); [Notice 2006-86](#)).** With two exceptions, if a child may be claimed as a qualifying child by 2 or more taxpayers for a taxable year, such individual shall be treated as the qualifying child of the taxpayer who is a parent of the individual, or if not a parent, the taxpayer with the highest adjusted gross income for such taxable year (§152(c)(4)(A)(i) & (ii)).

**Comment:** This means, starting in 2009, that the tie-breaker rules always apply whenever two or more parents can claim the individual as a qualifying child, regardless of whether they actually do so. Prior to 2009, two qualifying taxpayers could, among themselves, decide among themselves which would claim the qualifying child.

**Example:** Although never having married, Matt and Sara live together with their one biological child, Jack. Therefore, Jack is the qualifying child for both. As Sara's AGI is higher than Matt's AGI, starting in 2009, Matt cannot claim Jack as a qualifying child on his return, even if Sara does not claim Jack as a qualifying child on her return. Prior to 2009, Matt and Sara could decide, among themselves, which would claim Jack and, thereby, avoid the tie-breaking rules.

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

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

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

**Note:** If the child or individual fails to meet the previous five requirement to be considered a qualifying child, the individual may still be claimed as a "qualifying relative" dependent if they meet those requirements.

#### **§164: Deduction of State and Local General Sales Taxes Extended through the end of 2009** **([Emergency Economic Stabilization Act of 2008](#))**

**Claiming sales tax instead of income tax deduction on 2008 and 2009 tax returns.** Effective for taxable years prior to January 1, 2010, and at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes. Taxpayers are able to deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use optional sales tax tables created by the IRS (see Pub. 600). Taxpayers also may add to the table amount any sales taxes paid on: a motor vehicle, but only up to the amount of tax paid at the general sales tax rate; and an aircraft, boat, home (including mobile or prefabricated), or home building materials, if the tax rate is the same as the general sales tax rate.

#### **§165: Casualty Losses Attributable to Federally Declared Disasters ([Emergency Economic Stabilization Act of 2008](#))**

**Three major changes: (1) 10% AGI limit waived for personal "net disaster losses" in 2008 and 2009; (2) \$100 floor increased to \$500 in 2009; and (3) disaster losses can be added to standard deduction.** Casualty losses attributable to a federally declared disaster occurring after December 31, 2007, and before January 1, 2010, are deductible without regard to whether the losses exceed 10% of a taxpayer's adjusted gross income. For tax years beginning after December 31, 2008, and before January 1, 2010, a deduction for any casualty or theft loss is limited to the amount of the loss that exceeds \$500 (was \$100 for personal casualty or theft losses prior to 2008). Additionally, for tax years beginning after

December 31, 2007, the standard deduction is increased by the amount of any disaster loss amount.

**Waiver of 10% AGI limit for personal casualty losses.** The 10% of adjusted gross income limitation for a "net disaster loss" has been waived beginning after December 31, 2007. The term "net disaster loss" means the excess of personal casualty losses attributable to a "Federally declared disaster" occurring after December 31, 2007, and before January 1, 2010, occurring in a "disaster area," over personal casualty gains. The term "Federally declared disaster" means 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.

**Comment:** By statute, the midwest disaster between May 20, 2008 and August 1, 2008 is not eligible for these benefits.

The 10 % AGI limit continues to apply to casualty or theft losses that are not net disaster losses.

**Planner Point.** This has the effect of treating net disaster losses attributable to Federally declared disasters as a deduction separate from all other non-disaster casualty and theft losses.

**Disaster loss deduction to be included in standard deduction starting in 2008.** An individual taxpayer's standard deduction is increased by the "disaster loss deduction" for taxable years beginning after December 31, 2007. The "disaster loss deduction" is defined as the net disaster loss. Unlike the basic standard deduction, for purposes of calculating AMT income, the portion of the standard deduction amount attributable to the disaster loss deduction is allowed as a deduction (§56(b)(1)(E)).

**Note:** See [www.fema.gov/news/disasters.fema](http://www.fema.gov/news/disasters.fema) for a state by state listing of disaster declarations.

**Limitation per casualty increased from \$100 to \$500 in 2009.** The \$100 limitation per casualty has been increased to \$500 only for 2009, with the limit returning to \$100 in 2010.

**Example 1:** An individual taxpayer with \$100,000 of adjusted gross income has the following personal casualty items during the taxable year: \$5,000 personal casualty gain, \$30,000 allowable personal casualty loss attributable to a Federally declared disaster, and a \$7,000 allowable personal casualty loss. The deductible net disaster loss is \$24,900 (\$30,000 disaster casualty loss less the \$5,000 personal casualty gain and less the \$100 floor limitation). The deductible non-disaster casualty loss is \$0 (\$7,000 non-disaster casualty loss less \$10,000 (10% of AGI) limitation). The taxpayer's deductible net personal casualty loss for the taxable year is \$24,900 (the sum of the net disaster loss, the \$100 floor limitation and the excess of the other casualty losses over the 10% limitation).

## §222: Tuition Deduction ([Emergency Economic Stabilization Act of 2008](#))

**Tuition deduction extended through 2009.** Taxpayers are allowed an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Qualified higher education expenses are defined in the same manner as for purposes of the HOPE credit.

**Dollar limitation and phase-out rules exist.** The amount of deduction allowed for taxpayers depends on

the taxpayers AGI (§222(b)(2)(B)):

|                  | AGI does not exceed       | Eligible education expenses up to |
|------------------|---------------------------|-----------------------------------|
| <b>2008-2009</b> | \$65,000 (\$130,000 MFJ)  | \$4,000                           |
|                  | \$80,000 (\$160,000 MFJ)  | \$2,000                           |
|                  | >\$80,000 (>\$160,000MFJ) | \$ 0                              |

**Tuition deduction or education credit allowed.** Taxpayers are not eligible to claim the deduction and a Hope or Lifetime Learning Credit in the same year with respect to the same student. A taxpayer may not claim a deduction for amounts taken into account in determining the amount excludable due to a distribution (i.e., the earnings and contribution portion of a distribution) from a Coverdell ESA or the amount of interest excludable with respect to education savings bonds.

**New: Taxpayer must elect Hope/Lifetime if credits would create lower tax.** The qualified tuition deduction is unavailable to any taxpayer for any taxable year beginning in 2008 or 2009 if the taxpayer would, in the absence of the alternative minimum tax, have a lower tax liability for that year if he or she elected the Hope or Lifetime Learning credit with respect to an eligible individual instead of the qualified tuition deduction.

## **Chapter 2: IRA and Individual Retirement**

### **§408: Charitable Distributions from IRAs Extended to December 31, 2009 ([Emergency Economic Stabilization Act of 2008](#))**

An IRA owner, age 70½ or over, can directly transfer tax-free, up to \$100,000 per year to an eligible charitable organization. This provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Eligible IRA owners can take advantage of this provision, regardless of whether they itemize their deductions.

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

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

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

regular distributions.

### **Planning tips for transfers:**

1. Non itemizers get full benefit for the contribution and the full benefit of the standard deduction!
2. Since the IRA distribution made to a charity is not included in the client's taxable income, the many AGI related phaseouts are minimized. For example, the client does not experience
  - a. a phaseout of itemized deductions,
  - b. a 50% charitable contribution base limitation, or
  - c. an increase in the amount of social security benefits taxable as he or she would under prior law if the IRA distribution is included in AGI and then the amount paid over to the charity is deducted on his or her schedule A.
3. Clients will have to rethink the source of large charitable contributions during their lifetime. Perhaps the gift from an IRA will be a better choice than the gift of appreciated stock. Since the IRA produces income in respect of a decedent at the death of the account owner, leaving stock rather than the IRA may result in less tax to the beneficiary.
4. Distributions to donor advised funds, private foundations, charitable remainder trusts, and gift annuities do not qualify for this provision.
5. Distributions from a qualified retirement plan do not qualify for this provision.
6. Since the IRA distribution made to a charity is not included in the client's AGI, the Medicare B premium surcharge may be reduced if an IRA transfer is made directly to the charity.
7. The IRS has announced that no Form 1099-R is to be issued for IRA distributions made directly to a charity.

## **Chapter 3: Real Estate and Investment**

### **§108: Income Exclusion for Discharges of Acquisition Indebtedness on Principal Residences is Extended ([Emergency Economic Stabilization Act of 2008](#))**

The exclusion from gross income for discharges of qualified principal residence indebtedness is extended for three years, from January 1, 2010, through December 31, 2012.

## **Chapter 5: Business**

### **§132(f): Bicycle Commuters Fringe Benefit ([Emergency Economic Stabilization Act of 2008](#))**

**\$20 per month tax-free for riding a bike to work.** Beginning in 2009, a qualified bicycle commuting reimbursement fringe benefit has been added to the parking and mass transit qualified transportation fringe benefits. An employer may reimburse, as a tax-free fringe benefit, up to a maximum of \$20 per month for qualified bicycle commuting during a 15-month period beginning with the first day of such calendar year. The purpose is to reimburse the employee for reasonable expenses incurred during the calendar year for the purchase and repair of a bicycle, bicycle improvements, and bicycle storage, provided that the bicycle is regularly used for travel between the employee's residence and place of employment. The employee cannot receive any other qualified transportation fringe benefit (no double dipping with mass transit during the month). In addition, the employee must regularly use (i.e., the use can't be infrequent or constitute an insubstantial portion of the employee's commute) a bicycle for a

substantial portion of travel between the employee's residence and place of employment. The \$20 per month amount is not subject to inflation adjustment and may not be provided pursuant to an elective salary reduction agreement (§132(f)(4)).

**Comment:** More than 500,000 people commute to work by bicycle (per League of American Bicyclists).

**§168: 5-Year MACRS Depreciable Life For Farm Business Machinery and Equipment Placed in Service in 2009 ([Emergency Economic Stabilization Act of 2008](#))**

Any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business, the original use of which commences with the taxpayer after December 31, 2008, and which is placed in service before January 1, 2010 has a recovery period of five years under the General Depreciation System (GDS) and ten years under the Alternative Depreciation System (ADS) (§168(e)(3)(B)(vii); §168(g)(3)(B)).

**Comment:** Farm machinery and equipment generally had a seven-year recovery period under GDS (§168; Rev. Proc. 87-57).

**§168: Depreciable Life of Certain Restaurant Improvements or Building Reduced From 39 Years to 15 Years Extended Through 2009 ([Emergency Economic Stabilization Act of 2008](#))**

**Improvements on at least 3-year-old building with 50%+ used as restaurant.** A statutory 15-year straight-line recovery period is allowed for qualified restaurant property placed in service after October 22, 2004 and before January 1, 2010. Qualified restaurant property means any §1250 property that is an improvement to a building, if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals.

**Comment:** The 50% bonus depreciation deduction may not be claimed on any qualified restaurant property (§168(e)(7)(B), as amended by the Emergency Economic Act of 2008).

**New: A building placed in service after December 31, 2008 and before January 1, 2010.** The definition of qualified restaurant property has been expanded to include a building placed in service after December 31, 2008, and before January 1, 2010, if more than 50% of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals. A qualified restaurant building placed in service in calendar year 2009 is allowed a 15-year straight-line recovery period, whether or not the building is new construction. Surprisingly, there is no binding contract rule that prevents a taxpayer from using the 15-year recovery period if the building is acquired pursuant to an existing pre-2009 contract.

**Comment:** The 15-year life is non-elective, but as in the case of restaurant improvements, a taxpayer may be able to effectively elect out by electing ADS.

**§168: Depreciable Life of Certain Leasehold Improvements Reduced From 39 Year to 15 Years Extended Through 2009; Retail Improvements added for 2009 ([Emergency Economic Stabilization](#)**

Act of 2008)

**15-year qualified retail improvement property benefit added to leasehold improvement provision.**

Generally, leasehold and retail improvements must be depreciated over the life of the property using the MACRS method and not over the life of the lease [§168(i)(6)]. But a statutory 15-year straight-line recovery period for qualified leasehold improvement property placed in service after October 22, 2004 and before January 1, 2010 is available. In addition, starting for the first time in 2009, a qualified interior improvement to an over-3-year-old building used for a retail business will also be depreciable over 15 years straight-line method. This 15-year life rule is not elective, but the improvements do not lose their §1250 real property status, and therefore, the improvements do not qualify for 50% bonus depreciation or the §179 expensing allowance.

**Example - A terrible tax problem:** Hayes leases bare office space in downtown Chicago for a five-year period and is required to vacate the premise at the end of the lease. Hayes spends \$39,000 on improvements before occupancy. Hayes' amortization of the leasehold improvements is as follows:

|        | <u>Under MACRS</u> | <u>Between 10/04-12/07</u> |
|--------|--------------------|----------------------------|
| Year 1 | \$ 1,000           | \$ 2,600                   |
| Year 2 | \$ 1,000           | \$ 2,600                   |
| Year 3 | \$ 1,000           | \$ 2,600                   |
| Year 4 | \$ 1,000           | \$ 2,600                   |
| Year 5 | \$ 35,000          | \$28,600                   |
| Total  | <u>\$ 39,000</u>   | <u>\$39,000</u>            |

**Note.** The reason for the accelerated amounts in year 5 is that Hayes gets his normal depreciation or amortization plus the loss on abandoning his leasehold improvements! This is not a good deal! Economically Hayes has prepaid his taxes for years 1 through 4, and gets the prepaid taxes back in year 5.

**Qualified leasehold improvement property.** A qualified leasehold improvement property is defined as any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building.

The following modification was made by the JOBS Act to the definitions of qualified leasehold improvement property: if a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

**Qualified retail improvement property.** The term "qualified retail improvement property" means any improvement to an interior portion of a building which is nonresidential real property if such portion is

open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than 3 years after the date the building was first placed in service. In the case of an improvement made by the owner of such improvement, such improvement shall be qualified retail improvement property (if at all) only so long as such improvement is held by such owner (this means that a new buyer can not separately purchase the building and the previously inserted improvements, taking 15 year life on the improvements). The term “qualified retail improvements” shall not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building. Improvement placed in service before January 1, 2009 and after December 31, 2009, do not qualify (§168(e)(8)).

**§168(i): Inclusion of Cellulosic Biofuel in Bonus Depreciation for Biomass Ethanol Plant Property [\(Emergency Economic Stabilization Act of 2008\)](#)**

An additional 1<sup>st</sup> year bonus depreciation equal to 50% of the adjusted basis of qualified cellulosic biomass (this term has been substituted for biofuel) ethanol plant property is allowed. In order to qualify, the property generally must be placed in service after October 3, 2008 and before January 1, 2013. Qualified property now includes cellulosic biofuel, which is defined as any liquid fuel which is produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, including bagasse (from sugar cane), corn stalks, and switchgrass. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.

**§168(j): Accelerated Depreciation for Business Property on Indian Reservation [\(Emergency Economic Stabilization Act of 2008\)](#)**

With respect to depreciation deductions under §168(j) for certain property used in connection with the conduct of a trade or business within an Indian reservation are determined using the following recovery periods:

|                              |          |
|------------------------------|----------|
| 3-year property              | 2 years  |
| 5-year property              | 3 years  |
| 7-year property              | 4 years  |
| 10-year property             | 6 years  |
| 15-year property             | 9 years  |
| 20-year property             | 12 years |
| Nonresidential real property | 22 years |

These MACRS recovery periods that apply to qualified Indian reservation property have been extended for two years through December 31, 2009.

**§170: Enhanced Charitable Deduction for Contributions of Food Inventory Extended to 2008 and 2009 [\(Emergency Economic Stabilization Act of 2008\)](#)**

Any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory effective for contributions made before January 1,

2010. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10% of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. The enhanced deduction for food is available only for food that qualifies as "apparently wholesome food."

In addition, the 10% limitation is temporarily eliminated for food contributions by qualified farmers and ranchers on or after October 3, 2008 and before January 1, 2009, and instead treated like conservation contributions (§170(b)(3)).

**§170: Enhanced Charitable Deduction for Contributions of Book Inventory Extended to 2008 and 2009 ([Emergency Economic Stabilization Act of 2008](#))**

An enhanced deduction for C corporations for qualified book contributions to public schools is allowed for contributions made before January 1, 2010. Donee organization must certify that the book donation is suitable for its needs and useable in its educational program.

**§172: 5-Year Carryback for NOLs Created by Federally Declared Disasters ([Emergency Economic Stabilization Act of 2008](#))**

A special 5-year (instead of 2-year) carryback period for NOLs has been created for a qualified disaster loss. A qualified disaster loss is the lesser of:

1. the sum of:
  - a. §165 losses for the taxable year attributable to a Federally declared disaster occurring after December 31, 2007, and before January 1, 2012, and occurring in a disaster area, and
  - b. the deduction for the taxable year for qualified disaster expenses allowable under §198A(a) or which would be allowable as a deduction under that section if not treated as an expense in another Code section; or
2. the NOL for the taxable year.

The amount of the NOL to which the 5-year carryback period applies is limited to the amount of the corporation's overall NOL for the taxable year. Any remaining portion of the taxpayer's NOL is subject to the general 2-year carryback period. Ordering rules similar to those for specified liability losses apply to losses carried back under the provision.

Any taxpayer entitled to the 5-year carryback under this provision may elect to have the carryback period determined without regard to this option. In addition, the general rule which limits a taxpayer's NOL deduction to 90% of AMTI does not apply to any NOL to which the 5-year carryback period applies under the provision. Instead, a taxpayer may apply such NOL carrybacks to offset up to 100% of AMTI.

**§179D: Deduction for Energy-efficient Property Expenditures by a Commercial Building Owner Extended Through December 31, 2013 ([Emergency Economic Stabilization Act of 2008](#); [Notice 2008-40](#); [Notice 2006-52](#); [IR-2006-88](#))**

**How commercial building owners and leaseholders qualify for the new deduction of energy efficiency improvements by making their U.S. commercial buildings more energy efficient.**

Extended for five years is the ability for taxpayers to deduct (it's not a credit) the cost of energy-efficient property installed in commercial buildings if placed in service by December 31, 2013. Energy-efficient equipment must be installed as part of the commercial building's interior lighting systems, the heating, cooling, ventilation, or hot water systems, or the building envelope.

**"Energy efficient commercial building property"** is equipment that reduces annual total energy and power costs by 50% or more compared to a reference building that meets the minimum requirements of American National Standards Institute Standard 90.1-2001. The deduction may not exceed the excess (if any) of (1) the product of \$1.80 and the square footage of the building, over (2) the aggregate amount of the §179D deductions allowed with respect to that building in all prior tax years.

**Note:** The 50% targeted reduction applies to the overall energy savings, not the savings of any particular subsystem.

**A reduced deduction for those flunking the 50% reduction requirement.** A taxpayer is allowed a deduction for part or all of the cost of certain "partially qualifying energy efficient commercial building property," i.e., property that would qualify except for the failure to achieve the 50% reduction in energy and power costs but which is equipment that reduces the annual total energy and power costs by 16 2/3% or more compared to a reference building that meets those same minimum requirements. An interim alternate rule may apply in some circumstances. The deduction may not exceed the excess (if any) of (1) the product of \$0.60 and the square footage of the building, over (2) the aggregate amount of the §179D deductions allowed with respect to that building in all prior tax years.

**Certification from engineer-type is required.** Before a taxpayer may claim the §179D deduction, the taxpayer must obtain a certification with respect to the property showing that the overall energy and power costs reduced by 50% or more in connection with the installation of the property on or in a commercial building (§179D(c)(1)(D)). The IRS has established the process to obtain this certification, which must contain nine separate statements, a list of the components installed and includes a penalty of perjury statement. The IRS also provides a list of public software programs that must be used in calculating energy and power consumption for purposes of providing the certificate, which can be found at [http://www.eere.energy.gov/buildings/info/tax\\_credit\\_2006.html](http://www.eere.energy.gov/buildings/info/tax_credit_2006.html). The certification must be provided by a qualified individual, generally an engineer, and satisfy the requirements of §179D(c)(1). A taxpayer is not required to attach the certification to the return on which the deduction is taken.

**Comment:** The IRS estimates that the likely number of certifications is 20,000 (Notice 2006-52, Section 7).

**§198: Expensing of "Brownfield" Environmental Remediation Costs ([Emergency Economic Stabilization Act of 2008](#))**

Certain environmental cleanup costs, at the taxpayer's election, may be deducted in the tax year paid or incurred, rather than being capitalized, for both regular and AMT purposes, if the costs were incurred in connection with the abatement or control of hazardous substances at a "qualified contaminated site" (a.k.a. a "brownfield") [§198(b)]. These deductions, though are subject to recapture as ordinary income

upon a sale or other disposition of the property (§198(e)). The election to deduct environmental remediation costs has been extended for two years to cover expenditures paid or incurred before January 1, 2010.

**§199: Limitation of Deduction for Income Attributable to Domestic Production of Oil, Gas, or Primary Products ([Emergency Economic Stabilization Act of 2008](#))**

**§199 deduction for oil and gas companies limited to 6% in 2010.** The §199 deduction for taxpayers with oil related qualified production activities income for any taxable year beginning after 2009 is reduced by 3% of the least of: (1) oil related qualified production activities income of the taxpayer for the taxable year; (2) qualified production activities income of the taxpayer for the taxable year; or (3) taxable income (determined without regard to the §199 deduction). The term "oil related qualified production activities income" means qualified production activities income for any taxable year which is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof during such taxable year.

**§199: Modification of Domestic Production Activities Deduction for Film Production ([Emergency Economic Stabilization Act of 2008](#))**

Effective for taxable years beginning after December 31, 2007, a qualified film includes any copyrights, trademarks, and other intangibles with respect to a qualified film produced by the taxpayer and will not be affected by the methods and means of distributing the film. For example, the distribution of a qualified film via the internet (whether the film is viewed online or downloaded or whether or not there is a fee charged) is considered to be a disposition of the film for purposes of determining domestic production gross receipts (DPGR).

Effective for taxable years beginning after December 31, 2007, the W-2 wage limitation has been modified for qualified films by defining the term "W-2 wages" to include any compensation for services performed in the United States by actors, production personnel, directors, and producers. Thus, compensation is not restricted to W-2 wages for the limitation of qualified films. In addition, the Treasury regulation providing that an owner of a pass-thru entity is not treated as conducting the qualified production activities of the of the pass-thru entity, and vice versa, does not apply to these situations.

**New §457A: Modify Tax Treatment of Nonqualified Deferred Compensation from Certain Tax Indifferent Parties ([Emergency Economic Stabilization Act of 2008](#))**

Effective for services performed after December 31, 2008, compensation from nonqualified deferred compensation plans maintained by foreign corporations will generally become taxable, unless the compensation is deferred 12 months or less after the end of the year that the compensation vests.

**DISASTER RELIEF FOR BUSINESSES**

**New §198A: Expensing of Qualified Disaster Expenses ([Emergency Economic Stabilization Act of 2008](#))**

**Election to expense, rather than capitalize, qualified disaster expenses starting in 2008.** Costs otherwise required to be capitalized may be deducted in the taxable year paid or incurred to the extent incurred as a result of a Federally declared disaster that occurs before 2010. A taxpayer may elect to treat any qualified disaster expense that is paid or incurred by the taxpayer as a deduction for the taxable year in which paid or incurred effective after December 31, 2007. A qualified disaster expense is any otherwise capitalizable expenditure paid or incurred in connection with a trade or business or with "business-related property" that is:

1. for the abatement or control of hazardous substances that were released on account of a Federally declared disaster;
2. for the removal of debris from, or the demolition of structures on, real property damaged or destroyed as a result of a Federally declared disaster; or
3. for the repair of business-related property damaged as a result of a Federally declared disaster.

For purposes of this provision, "business-related property" is property held by the taxpayer for use in a trade or business, for the production of income, or as inventory, and a Federally declared disaster is any disaster occurring after December 31, 2007, and before January 1, 2012, that is 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.

**Recaptured as ordinary income.** For purposes of ordinary income recapture, any deduction allowed under this provision is treated as a deduction for depreciation and §1245 property for purposes or depreciation recapture.

**§168(n): Special Depreciation Allowance for Qualified Disaster Assistance Property ([Emergency Economic Stabilization Act of 2008](#))**

For 2008 and 2009, an additional 50% first-year (bonus) depreciation of the adjusted basis of real and personal business property purchased (and placed into service) to rehabilitate or replace similar property destroyed or condemned as a result of a presidentially declared disaster is permitted. The basis of the property is first reduced by any §179 allowance, including the special §179 allowance on disaster assistance property. No AMT adjustment is required. The tax benefits of the bonus depreciation must be recaptured as ordinary income in a tax year in which the qualified disaster assistance property ceases to be qualified disaster assistance property

**Qualified disaster assistance property is defined as:**

1. New or used MACRS recovery property with an recovery period of 20 years or less, computer software that is depreciable over three years, water utility property, or qualified leasehold improvement property or nonresidential real property or residential rental property;
2. Substantially all of the use of which is in a federally declared disaster area occurring before January 1, 2010, and in the active conduct of the taxpayer's trade or business in that disaster area;
3. The property must rehabilitate property damaged, or replace property destroyed or condemned, as a result of a federally declared disaster and be similar in nature to, and located in the same county as, the property being rehabilitated or replaced (an integrated plan will qualify);
4. The original use of the property in the disaster area must commence with the eligible taxpayer on

- or after the applicable disaster date;
5. The property must be purchased by the eligible taxpayer on or after the applicable disaster date and a written binding contract for the acquisition could not be effect before that date. It cannot be a transaction between related parties or members of the same controlled group and the transferee's basis in the property cannot be determined by reference to the transferor's basis (see §179(d) for definition of purchase for this purpose);
  6. The property must be placed in service by such eligible taxpayer on or before the date which is the last day of the third calendar year following the applicable disaster date (or the fourth calendar year in the case of nonresidential real property and residential rental property).

**Comment:** This 50% bonus depreciation for disaster assistance property is designed to be a significant incentive for taxpayers to rebuild property damaged by federally declared disasters occurring after December 31, 2007, and before January 1, 2010. By requiring the replacement property be placed in service within three (or four) years of the end of the calendar year of the disaster, Congress wants taxpayers to proceed quickly with their rebuilding plans.

**Exceptions.** "Qualified disaster assistance property" shall not include:

1. most other property already eligible for §168(k) bonus depreciation (unless an election is made to forgo bonus depreciation in favor of an accelerated research or AMT credit (§168(k)(4));
2. cellulosic biomass ethanol plant property, and qualified refuse and recycling property;
3. Go Zone property qualifying for bonus depreciation;
4. any property used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property;
5. property that must use the alternative depreciation system (but not if ADS can be elected);
6. property financed by tax-exempt bonds;
7. buildings that qualify for the commercial revitalization deduction; and
8. all property in any class of property in which the taxpayer elected out of bonus depreciation.

Special rules exist for self-constructed property, sale-leaseback property and pre-2008 contracts to acquire or produce it.

### **§179: Increased Expensing for Qualified Disaster Assistance Property ([Emergency Economic Stabilization Act of 2008](#))**

**\$350,000 §179 with \$1.4 million phaseout limit.** For qualified §179 disaster assistance property placed in service after December 31, 2007, with respect to disasters declared after December 31, 2007, the §179 expense deduction increased by \$100,000 (or, if less, the cost of qualified §179 disaster assistance property placed in service during the tax year) to \$350,000 in 2008. The phaseout limitation is increased by \$600,000 (or, if less, the cost of qualified §179 disaster assistance property placed in service during the tax year) to \$1.4 million in 2008.

## **BUSINESS CREDITS**

**§30C: Extension and Modification of Alternative Fuel Vehicle Refueling Property Credit**  
**(Emergency Economic Stabilization Act of 2008)**

The credit for installing alternative fuel refueling property, other than property relating to natural gas, compressed natural gas (CNG), liquefied natural gas (LNG), or hydrogen has been extended for one year (through 2010). The credit for property relating to natural gas, CNG, and LNG is extended through 2014 for depreciable property and through 2017 for nondepreciable property. (The provision does not extend the credit for property relating to hydrogen, which continues through 2014.) For purposes of the credit, the definition of a clean-burning fuel is modified to include electricity. The credit amount has increased to 50% of the cost of the qualified property. It also raised to \$50,000 per taxable year, per location, the limit with respect to depreciable qualified property. With respect to qualified property that is not subject to depreciation, the limit was raised to \$2,000 per taxable year.

**§41: Research Tax Credit Extended Through December 31, 2009** **(Emergency Economic Stabilization Act of 2008)**

The research credit has been extended for two years, through December 31, 2009. The §41 research tax credit has never been a permanent provision of the federal tax code. Since its enactment in mid-1981, the credit has been extended 13 times and significantly modified five times. While the credit is often thought of as a single unified credit, it has five components (reduced to four components in 2009): (1) a regular credit, (2) an alternative incremental credit (AIRC) [terminated for tax years after December 31, 2008], (3) an alternative simplified credit (ASIC) [increased from 12% to 14% of the qualified research expenses that exceeds 50% of the average qualified research expenses for the prior three tax years starting for tax years ending after December 31, 2008 ], (4) a basic research credit, and (5) an energy research credit. All but the energy research credit are incremental in that the credit applies only to qualified research spending above a base amount.

**§45: Extension and Modification of Renewable Energy Production Tax Credit** **(Emergency Economic Stabilization Act of 2008)**

**Extension of placed-in-service date for qualifying facilities.** The period during which qualified facilities producing electricity from closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, municipal solid waste, and qualified hydropower may be placed in service for purposes of the electricity production credit has been extended through December 31, 2010. The placed-in-service period for qualified wind and refined coal production facilities has been extended through 2009.

**Addition of marine and hydrokinetic renewable energy as a qualified resource.** Marine and hydrokinetic renewable energy as a qualified energy resource (e.g., waves, tides, and even currents from free flowing water) and marine and hydrokinetic renewable energy facilities as qualified facilities has been added.

**Phaseout replaced by limitation based on investment in facility.** The electricity production credit phaseout has been replaced with an annual limit on the total credits that may be claimed with respect to any qualified facility placed in service after 2009 based on the investment in the facility.

**Preparer tip:** This credit is computed on Form 8835, Renewable Electricity Production Credit.

Technical definitions were updated, and the rules for the refined coal credit and trash combustion facilities were modified.

**§45A: Indian Employment Tax Credit ([Emergency Economic Stabilization Act of 2008](#))**

The Indian employment tax credit was extended for two years through December 31, 2009. Form 8845, Indian Employment Credit is used to compute the credit.

**§45D: The New Markets Tax Credit Extended Through 2009 ([Emergency Economic Stabilization Act of 2008](#))**

The "new markets tax credit" for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE") has been extended for one year, through 2009.

**§48: Extension and Modification of Energy Investment Credit ([Emergency Economic Stabilization Act of 2008](#))**

Energy credits and energy credit rates have been extended for eight years, through December 31, 2016, including the 30% investment tax credit for solar energy property and qualified fuel cell property and the 10% investment tax credit for microturbines. Combined heat and power system property is eligible for a new 10% energy credit and a new 30% credit is available for small wind energy property. The \$500 per half kilowatt of capacity credit cap with respect to fuel cells has been raised to \$1,500 per half kilowatt of capacity. Also, the restrictions on public utility property being eligible for the credit were repealed. The energy credit may now be used to offset the alternative minimum tax. Combined heat and power ("CHP") property are eligible for the 10% energy credit through December 31, 2016.

**§40A, §6426; §6427: Credits for Biodiesel and Renewable Diesel ([Emergency Economic Stabilization Act of 2008](#))**

The biodiesel fuels general business credit (the "biodiesel fuels credit") is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. This credit has been extended for fuel sold or used after December 31, 2008 and before January 1, 2010, a one year extension. Both biodiesel and agri-biodiesel are entitled to a credit of \$1.00 per gallon. In addition, the definition of renewable diesel has been modified. Lastly, IRS Notice 2007-37 has been overridden with respect to co-produced fuel, providing that renewable diesel does not include any fuel derived from co-processing biomass with a feedstock that is not biomass. The de minimis use of catalysts, such as hydrogen, is now permitted, effective for fuel produced, and sold or used, after February 13, 2008.

**§45L(g): Credit for Builder/Manufacturer of New Energy Efficient Home Effective through 2009 ([Emergency Economic Stabilization Act of 2008](#); [IR-2006-32](#); [Notice 2006-28](#))**

**Builder.** An eligible contractor who constructs a qualified new energy efficient home may qualify for a credit of up to \$2,000. Site-built homes qualify for a \$2,000 credit if they reduce energy consumption by 50% relative to the International Energy Conservation Code standard.

**Manufacturer.** The credit is available for all new homes, including manufactured homes constructed in accordance with the Federal Manufactured Homes Construction and Safety Standards. Manufactured homes can qualify for a \$1,000 or \$2,000 credit, depending on the level of energy savings achieved, by meeting Energy Star standards. The guidance provides information about the certification process that a builder must complete to qualify for the credit. The guidance also provides for a public list of software programs that may be used in calculating energy consumption for purposes of obtaining a certification. The IRS provided guidance in Notice 2006-27 and Notice 2007-28 that describes the certification process for establishing that the home builder (or manufactured home producer) meets the efficiency standards required for the credit (§45L(d)).

The home qualifies for the credit if:

- It is located in the United States;
- Its construction is substantially completed after August 8, 2005;
- It meets the statutory energy saving requirements, and
- It is acquired from the eligible contractor after December 31, 2005, and before January 1, 2010, for use as a residence (§45L).

The credit applies to new construction as well as “substantial reconstruction and rehabilitation.” In general, to meet the energy saving requirements, a home must be certified to provide a level of heating and cooling energy consumption that is at least 30% to 50% in the case of manufactured homes, and 50% for other homes below that of a comparable home constructed in accordance with the standards of the 2004 Supplement to the 2003 International Energy Conservation Code. It must also have building envelope component improvements providing a level of heating and cooling energy consumption that is at least 10% below that of a comparable home.

**Preparer Pointer:** The contractor will need to verify that the home is used by the purchaser as a residence and will probably need some sort of a letter from the home buyer certifying the use.

[Notice 2006-27](#) provides guidance on the credit for construction of energy efficient homes. Guidance for manufactured homes is provided in Notice 2006-28.

**Basis.** Basis in the property must be reduced to the extent of any energy efficient home credit allowed (§1016(a)(33)).

## **Chapter 6: Payroll and Self-Employment Tax**

### **Misc.: Extension of the Hurricane Katrina Work Opportunity Tax Credit ([Emergency Economic Stabilization Act of 2008](#))**

The work opportunity tax credit for certain Hurricane Katrina employees employed within the core disaster area has been extended to four years or until August 28, 2009. For this purpose, a Hurricane Katrina employee employed within the core disaster area is an individual who on August 28, 2005, had a principal place of abode in the core disaster area and is hired on or after August 28, 2005 and before August 29, 2009 for a position, the principal place of employment of which was located in the core disaster area. The other special rules (e.g., certification and previous employment) for Hurricane Katrina

employees apply.

## **Chapter 8: C and S Corporation**

### **CORPORATE CHARITABLE CONTRIBUTIONS AND GIFTS §170**

#### **§170: Corporate Donation of Scientific Property Used for Research and of Computer Technology and Equipment Extended Through 2009 ([Emergency Economic Stabilization Act of 2008](#))**

Businesses are encouraged to contribute computer equipment to elementary, secondary, and post-secondary schools by allowing an enhanced deduction for such contributions. The deduction has been extended through December 31, 2009. The law also allows equipment "assembled by" the donor to qualify for the enhanced deduction.

#### **§582(c)(1): Bank's Fannie Mae and Freddie Mac Preferred Stock Eligible for Ordinary Gain or Loss Treatment ([Emergency Economic Stabilization Act of 2008](#))**

When the preferred stock in the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac") became worthless with the Federal government bailout, numerous qualified financial institutions, such as banks, mutual savings banks and building and loan institutions, became eligible for ordinary income or loss treatment on the sale or exchange after December 31, 2007.

#### **§162(m) & §280G: Executive Compensation Limited to \$500,000 for Financial Institutions Participating in the Troubled Asset Relief Program ([Emergency Economic Stabilization Act of 2008](#))**

**Compensation and golden parachutes limited; "claw-back" provision introduced.** When assets are acquired by Treasury Department under the "troubled asset relief program" (TARP) by means of a *public auction*, the applicable financial institutions are restricted for an applicable period of time from deducting more than \$500,000 for executive compensation for the CEO, CFO and the top three highest compensated officers. Numerous additional restrictions also apply to the golden parachute rules. In addition, a firm that sells troubled assets *directly* to the government must eliminate incentives to take unnecessary risks; take back any bonuses paid to senior executives based on materially inaccurate information (a "claw back" provision); and not make any golden parachute payments to senior executives while the government holds an equity or debt position in the firm. The TARP authorities period begins on October 3, 2008 and extends through 2009.

#### **§1367: Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property ([Emergency Economic Stabilization Act of 2008](#))**

If an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability. A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.

In the case of contributions made in taxable years beginning after December 31, 2005, and before January 1, 2010 (extended for two years by the Emergency Economic Stabilization Act of 2008), the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2007, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

## **Chapter 10: IRS Practice and Procedure**

### **§6045, §6045A, §6045B: Broker Reporting of Customer's Basis in Securities Transactions ([Emergency Economic Stabilization Act of 2008](#))**

**Form 1099-B's will report adjusted basis for all stock sales starting in 2011.** Every broker is required to file an information return reporting the gross proceeds and the adjusted basis of a covered security and whether any gain or loss is short-term or long-term. This reporting requirement starts for the sale of any share of corporate stock on or after January 1, 2011. If the average basis method is used (e.g., acquired through a periodic stock investment stock or stock in a regulated investment company), the reporting requirement starts for sales on or after January 1, 2012. For all other covered securities, the reporting requirement starts for sales on or after January 1, 2013. Brokers generally will be required to report gross proceeds and basis information to customers even if they are S corporations.

**Most security sales are covered.** A covered security is any specified security such as any share of stock in a corporation (including stock of a regulated investment company); any note, bond, debenture, or other evidence of indebtedness; any commodity or a contract or a derivative with respect to the commodity if the IRS determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the IRS determines that adjusted basis reporting is appropriate. Certain securities acquired by gift or inheritance are not covered securities.

**“First-in, first-out method” (FIFO) must be used to compute adjusted basis unless investor specifically identifies stock sold.** If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule"). If a taxpayer makes an adequate identification of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified. A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations.

**Exception for wash sales.** Generally, a customer's adjusted basis in a covered security is determined without taking into account the effect on basis of the §1091 wash sale rules. If, however, the acquisition and sale transactions resulting in a §1091 wash sale occur in the same account and are in identical securities, adjusted basis is determined by taking into account the effect of the wash sale rules. Securities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures (CUSIP) number.

**Special rules for short sales.** When a broker lends an investor's securities for use in a short sale and receives a payment in lieu of a dividend or tax-exempt interest on the customer's behalf during the period the short sale is open, the broker must send the investor a written notice identifying the gross proceeds and basis reporting under §6045, generally in the year in which the short sale is closed (rather than, as under the pre-2011 rule for gross proceeds reporting, the year in which the short sale is entered into).

**Certain options excluded.** Even certain options will now have to be reported. If a covered security is acquired or disposed of by reason of the exercise of an option that was granted or acquired in the same account as the covered security, the amount of the premium received or paid with respect to the acquisition of the option is treated as an adjustment to the gross proceeds from the subsequent sale of the covered security or as an adjustment to the customer's adjusted basis in that security. Gross proceeds and basis reporting is also required when there is a lapse of, or a closing transaction with respect to, an option on a specified security or an exercise of a cash-settled option. Reporting is required for the calendar year that includes the date of the lapse, closing transaction, or exercise.

**Example:** If a taxpayer acquires for \$5 a cash settlement stock option with a strike price of \$100 and settles the option when the stock trades at \$120, a broker through which the acquisition and cash settlement are executed is required to report gross proceeds of \$20 from the cash settlement and a basis in the option of \$5.

For purposes of the reporting requirement for closing transactions, a closing transaction includes a mark-to-market under §1256. It is intended that a specified security for purposes of the reporting rules includes a stock index such as the S&P 500. The reporting rules related to option transactions apply only to options granted or acquired on or after January 1, 2013.

**Must provide Form 1099-B to customers by February 15, not January 31.** The present-law January 31 deadline for furnishing certain information statements to customers has been changed to February 15. The statements to which the new February 15 deadline applies are: (a) statements showing gross proceeds (under §6045(b)) or substitute payments (under §6045(d)) and (b) statements with respect to reportable items (including, but not limited to, interest, dividends, and royalties) that are furnished with consolidated reporting statements. This provision applies to statements required to be furnished after December 31, 2008.

Any issuer of a specified security is required to file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the IRS (new §6045B). This return must be filed within 45 days after the date of the organizational action or, if earlier, by January 15 of the year following the calendar year during which the action occurred.

**Broker-to-broker and issuer reporting.** Every broker must furnish to the transferee broker a written statement that allows the transferee broker to satisfy the provision's basis and holding period reporting requirements.

**§6694: MLTN Repealed! Proposed Regulations Released On Increased Tax Preparer Penalties When Client's Tax Liability Understated ([Emergency Economic Stabilization Act of 2008](#); [§6694](#);**

## [NPRM REG-12943-07](#)

On October 3, 2008, Congress reduced the tax preparer standard for undisclosed positions from the (51%) “more likely than not” (MLTN) standard to “unless there is or was (a  $\pm$ 40%) substantial authority for the position,” making this change retroactive for returns prepared after May 25, 2007<sup>2</sup>. No longer does a tax preparer face a potential \$1,000 fine every time one line on a client’s return is changed in audit! The MLTN will only apply to undisclosed positions with respect to tax shelters and reportable transactions.

Also this year, the IRS released proposed regulations, which provide guidance on the now repealed MLTN preparer standard but also updated all preparer penalties. Because of the retroactive legislative repeal of the MLTN standard, many of these regulations are no longer applicable.

In 2008, the IRS revised the regulatory scheme governing tax return preparer penalties, which had remained substantially unchanged since the late 1970's. These proposed return preparer penalty regulations, which replace [Notice 2008-11](#); [Notice 2008-12](#); [Notice 2008-13](#), provide guidance on the application of the tax return preparer penalties as amended by the Small Business and Work Opportunity Tax Act of 2007.

**New preparer penalties have major impact on small preparation firms!** The IRS “estimates” there are 38,566 tax return preparation firms and 260,338 self-employed tax return preparers that qualify as small entities. The IRS clearly admits that these proposed rules will have an impact on a substantial number of small entities.

**Comment:** With the passage of the MLTN standard, Congress’s reaction to the sale of corporate tax shelters, such as Son of Boss, punished not only the larger CPA firms who aggressively marketed them, but also the 99% of the generally more conservative tax preparation firms that refused to have anything to do with tax shelters. ***Punishing all for the sins of few was bad tax policy!*** That policy was reversed when Congress replaced the MLTN standard with the “unless there is or was (a  $\pm$ 40%) substantial authority for the position” standard.

**Firms must keep list of all preparers, clients, and retain complete copy of all prepared returns.** The statute and proposed regulations require entities that employ tax return preparers to retain a record of the name, taxpayer identification number and principal place of work of each tax return preparer employed. Tax return preparers are also required to retain a complete copy of a return (or claim for refund) or a list of the name, taxpayer identification number and taxable year for each return (or claim for refund) and the name of the tax return preparer required to sign the return or claim for refund.

**Higher preparer standards and penalties for expanded list of preparers.** The Small Business and Work Opportunity Tax Act of 2007 amended several provisions of the Code to:

- extend the application of the income tax return preparer penalties to all tax return preparers,
- alter the standards of conduct that must be met to avoid imposition of the §6694(a) penalty for

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<sup>2</sup> As the MLTN standard was effective on May 25, 2007, this retroactive change results in the MLTN standard being inapplicable to most tax preparers, other than tax shelter promoters.

- preparing a return which reflects an understatement of liability, and increase applicable penalties under §6694(a) and (b).

**Understatement of liability required - no preparer penalty with a no-change audit.** The \$1,000 (or 50% of income) §6694(a) penalty is only imposed on a preparer when the tax return reflects an understatement of liability. An understatement of liability exists if, viewing the return or claim for refund as a whole, there is an understatement of the net amount payable, or an overstatement of the net amount creditable or refundable, but the net amount payable cannot be reduced by any carryback. This tax does not include additions to the tax, additional amounts, and assessable penalties (PR §1.6694-1(c)). If a penalty has been assessed and later it is established in a final administrative determination or a final judicial decision that there was no understatement of liability relating to the position(s) on the return or claim for refund, then the assessment shall be abated without consideration of any period of limitations (PR §1.6694-1(d)).

**Preparer penalties increased.** When there is an understatement due to an “unreasonable position” (i.e., the tax return preparer knew or reasonably should have known “unless there is or was [a ±40%] substantial authority for the position”), the §6694(a) penalty was increased from \$250 to the greater of \$1,000 or half the income derived by the preparer with respect to the return. For “willful or reckless conduct” by the preparer, the §6694(b) penalty was increased from \$1,000 to the greater of \$5,000 or half the income derived by the preparer with respect to the return. This penalty can be avoided if the preparer demonstrates that there is a *reasonable* cause for any position and the preparer acted in good faith (PR §1.6694-2(a); PR §1.6694-3(a)).

| If understatement due to unreasonable position (should have known) & | Starting 5/27/07                                  | Up to 5/27/07 |
|--|---|---------------|
| Unreasonable position taken:   | <b>\$1,000 or 50% of income</b>                   | \$250         |
| Willful or reckless conduct:   | <b>\$5,000 or 50% of income</b>                   | \$1,000       |
| But, no penalty if:  | Reasonable cause and preparer acted in good faith |               |

***Income derived (or to be derived) with respect to the return or claim for refund.*** Income derived (or to be derived) means all compensation the tax return preparer (or preparer’s firm) receives or expects to receive for tax return preparation, claim of refund, or providing tax advice (including research and consultation) that gave rise to the understatement (PR §1.6694-1(f)(1)).

***No pre-transaction planning penalty; e.g., advise given on events that have not yet occurred; penalty applies only to post-transaction advice.*** Only compensation for tax advice that is given about events that have occurred at the time the advice is rendered and that relates to the position(s) giving rise to the understatement will be taken into account for purposes of calculating the §6694(a) & (b) penalties.

**\$5,000 (or 50% of income) reckless or intentional disregard of IRS rules/regulations.** A preparer recklessly or intentionally disregards a rule or regulation if the preparer takes a position on the return or refund claim that is contrary to a rule or regulation that the preparer knows of or is reckless in not knowing of (PR §1.6694-3(e)).

**Example - reckless or intentional disregard.** Sammy provided CPA Nancy Shott with detailed check registers reflecting personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. Nancy knowingly deducted the expenses of Sammy's domestic help as wages paid in his business. Nancy is subject to the \$5,000 (or 50% of income) §6694(b) penalty (PR §1.6694-3(d), Exp. 1)

**Example - reckless or intentional disregard.** Linda provided EA Bob with detailed check registers to compute her expenses. Bob, however, knowingly overstated the expenses on the return. After adjustments by the examiner, the tax liability increased significantly. Because Bob disregarded information provided in the check registers, he is subject to the \$5,000 (or 50% of income) §6694(b) penalty (PR §1.6694-3(d), Exp. 2)

**Definition of "returns."** §301.7701-15(b)(4) and Exhibit 1 and 2 of Notice 2008-13 include a complete list of returns that may subject the preparer to penalty. Returns included are:

- income tax returns
- estate and gift tax returns
- employment tax returns
- miscellaneous excise tax returns
- passthrough returns
- Forms 5500

**Preparer Pointer.** Generally preparation of Forms W-2, 1099, 990, 1040ES, extensions, 8109 and 8027 do not subject the preparer to penalty unless they are prepared with a reckless or intentional disregard of rules and regulations (Exhibit 3, Notice 2008-13).

**Both signing and non-signing tax return preparers may be subject to penalty.** Any person who prepares for compensation, or who employs one or more persons to prepare for compensation (the firm), all or a substantial portion of any return of tax or any claim for refund of tax, is a tax return preparer subject to a §6694 penalty, whether they are a "signing tax return preparer" (one who signs or is required to sign the return or claim for refund) or a "nonsigning tax return preparer" (PR §301.7701-15(a); PR §301.7701-15(b)(1)). A nonsigning tax return preparer may have prepared all *or a substantial portion* of a return or claim for refund but didn't sign the return. This includes individuals who provide advice (written or oral) to a taxpayer (or to another tax return preparer) when that advice constitutes a substantial portion of the return, e.g., more than 5% of the aggregate time incurred with respect to each position causing the understatement (PR §301.7701-15(b)(2)(i)).

**Comment:** Therefore, a like-kind exchange accommodator may meet the definition of a nonsigning tax return preparer.

***A substantial portion of a return is broadly defined; but relief for the non-signer is available if understatement is <\$10,000.*** A single tax entry may constitute a substantial portion of the tax shown on a return. Additional factors to consider in determining whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion, are the size and complexity of the item relative to the taxpayer's gross income and the size of the understatement attributable to the item compared to the taxpayer's reported tax liability. A de minimis exception to this rule applies if the item giving rise to the

understatement is (i) less than \$10,000, or (ii) less than \$400,000 if the item is also less than 20% of the taxpayer's gross income (or, for an individual, the individual's adjusted gross income). Remember, this de minimis rule does not apply to signing tax return preparers (PR §301.7701-15(b)(3)).

**Example:** The person preparing a cost segregation study may be subject to a preparer penalty if the size of the deficiency related to the depreciation deduction is substantial to the individual's tax return.

**Example:** The preparer of a Form 1065 or Form 1120S may be deemed to be the preparer of any of the partners' or shareholders' individual income tax returns, if the items on the pass through return constitute a substantial portion of the owner's income tax return (§301.7701-15(b)(3)). Thus the preparer of a K-1 may be subject to a preparer penalty if the size of the deficiency related to the K-1 reporting is substantial to the individual's tax return.

***Certain preparers are exempt from penalty.*** The proposed regulations exempt certain tax return preparers, such as:

- a Volunteer Income Tax Assistance (VITA) and Low-Income Tax Clinic (LITC) preparers,
- certain tax counselors for the elderly (see Revenue Act of 1978, Section 163),
- an office tax return processor,
- an officer/partner or employee of the taxpayer,
- a fiduciary,
- a preparer not working for explicit or implicit compensation, and
- an individual who prepares a claim for refund for a taxpayer in response to a notice of deficiency issued to the taxpayer (PR §301.7701-15(b)(4)(f)(1)).

**When are preparers responsible for what they don't know? Preparer is not required to verify information provided by a client or a third party...unless it appears incorrect or incomplete.** A tax return preparer may rely in good faith and without verification upon information furnished:

- to the IRS in a previously filed tax return prepared by another preparer or the taxpayer,
- by the taxpayer,
- by another advisor,
- by another tax return preparer or
- other party (including another advisor or tax return preparer at the tax return preparer's firm),

unless, of course, it attempts to represent legal conclusions on Federal tax issues. Therefore, the tax return preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer, and must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. For example, a tax return preparer who prepares an amended return (including a claim for refund) need not verify the positions on the original return, but must make reasonable inquiries if the information appears to be incorrect or incomplete (PR §1.6694-1(e)(1) & (2)).

**Important:** The tax return preparer must confirm that the position being relied upon has not been adjusted by examination or otherwise.

**Tax preparer must ask if logs and appraisals, etc. exist before allowing the deduction.** If tax provisions require that specific facts and circumstances exist (for example, that the taxpayer maintain specific documents such as appraisals or logs) before a deduction or credit may be claimed, the tax return preparer must make appropriate inquiries to determine the existence of these documents as a condition of the claiming of a deduction or credit (PR §1.6694-1(e)(1)).

**Example - Preparer must ask if appraisal exists on charitable contributions over \$5,000.** During an interview conducted by CPA John, his client, Arnold, stated that he had made a charitable contribution of real estate in the amount of \$50,000 during the tax year, when in fact he had not made this charitable contribution. If John does not inquire about the existence of a qualified appraisal or complete a Form 8283, Noncash Charitable Contributions and includes the charitable contribution deduction on Arnold’s tax return which resulted in an understatement of liability for tax, and signed the tax return as the tax return preparer, John will be subject to a §6694 penalty (PR §1.6694-1(e)(3), Exp. 1).

**Example - a non-disclosed Form 1099 does not generate penalty.** While preparing the 2008 tax return for an individual taxpayer, EA Bill realizes that Donald, his client, did not provide a Form 1099 for a bank account that produced significant taxable income in 2008. When Bill inquired about any other income, Donald furnished the Form 1099 to him for use in preparation of the 2008 tax return. Bill did not know that Donald owned an additional bank account that generated taxable income for 2008 and Donald did not reveal this information to Bill notwithstanding Bill's general inquiry about any other income. Bill signed Donald’s return as the tax return preparer. Bill is not subject to a §6694 penalty (PR §1.6694-1(e)(3), Exp. 2).

**Taxpayer and preparer standards the same.** Both taxpayers and tax preparers must have a substantial authority (40% possibility of sustaining their position).

| <b>Level of Confidence for Return Position (percentages are approximate)<br/>for Returns Filed after 12-31-07</b> |  |   |
|---|--|---|
|   | <b>Tax Return Preparer<br/>(to avoid preparer penalties)</b>         | <b>Taxpayer (to avoid accuracy<br/>related penalty)</b> |
| <b>No disclosure</b>  | <i>NEW: Substantial authority-<br/>± 40%</i>                         | Substantial authority-<br>± 40%                         |
| <b>Tax shelter Item<br/>No disclosure</b>   | More likely than not-<br>>50% or reasonable basis with<br>disclosure | More likely than not-<br>>50%                           |
| <b>Adequate disclosure required</b>   | Reasonable basis<br>± 20% to 25%                                     | Reasonable basis<br>± 20% to 25%                        |

**“Substantial authority” replaces “realistic possibility of success” standard before signing client’s**

**tax return.** The [Emergency Economic Stabilization Act of 2008](#) retroactively restated the preparer's standards of conduct that must be met to avoid the imposition of the penalties with respect to undisclosed positions on a return with an understatement of tax. Congress has replaced the "realistic possibility of success" standard for undisclosed positions (which was a 1-in-3 level of confidence, or greater, that the position would be sustained on its merits if challenged by the IRS) with "there is or was substantial authority for the position," which commonly has been interpreted as a  $\pm$  40% level of confidence (PR §1.6694-2(b)(1)).

**Preparer Pointer.** The preparer may not take into consideration the possibility that the tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled in determining if a position is more likely than not to be sustained.

**Qualified, and non-qualified authorities.** The substantial authority requirement must be satisfied on the date the return is prepared and must be based on one or more authorities, such as Code, regulations, court cases, Revenue Rulings, and even Private Letter Ruling (PR §1.6694(2)(b)(6); PR §1.6694-2(b)(3); see §1.6662-4(d)(3)(iii) for a more complete list). Authorities, for this purpose, will not include legal opinions prepared by tax professionals or legal periodicals, such as CCH's Master Tax Guide, or even this manual.

**Preparer note:** The higher "more likely than not standard" is part of FIN 48. FIN 48 (FASB Interpretation Number 48, Accounting for Uncertainty in Income Taxes) provides guidelines on when and to what extent uncertain tax positions taken by businesses should be recognized for financial accounting purposes.

**Disclosure based on reasonable basis may also relieve tax preparer from §6694 penalty.** When a position taken on a tax return where the required "substantial authority" standard cannot be reached, disclosure of the position is required to avoid the §6694 penalty. But, disclosure alone isn't enough; a disclosed position must have *at least* a "reasonable basis" (20%-25% level of confidence if challenged by the IRS) of being sustained on its merits to avoid the §6694 preparer penalties. To meet the "reasonable basis" standard, a tax return preparer may rely in good faith, without verification, upon information furnished by a taxpayer, advisor, another tax return preparer, or other party (even when the advisor or tax return preparer is within the tax return preparer's same firm) [PR §1.6694-2(c)(2)]. For disclosed positions, the "reasonable basis" standard replaced "the not-frivolous" (a very low 10%-15% level of confidence if challenged by the IRS) standard.

**Adequate disclosure rules for preparer signing tax return.** For a signing tax return preparer, a position may be disclosed in one of five ways.

1. **Return filed with Form 8275/Form 8275-R.** The position may be disclosed on a properly completed and filed [Form 8275](#), Disclosure Statement ([also see instructions](#)), [or Form 8275-R](#), Regulation Disclosure Statement ([also see instructions](#)), as appropriate, or on the tax return in accordance with an IRS annual revenue procedure (e.g., [Rev. Proc. 2008-14](#)) [§1.6694-2(c)(3)(i)(A)].
2. **Tax return delivered to client with Form 8275/Form 8275-R attached.** For income tax returns, if the position meets the  $\pm$  40% "substantial authority" standard (see §1.6662-4(d)), disclosure of the position is adequate if the tax return preparer provides the taxpayer with a

prepared tax return that includes the appropriate disclosure (§1.6694-2(c)(3)(i)(B)). There is no requirement that the tax preparer be assured the taxpayer has actually filed the return with the Form 8275 or Form 8275-R attached.

3. **The big speech ...and be able to prove it:** For income tax returns, if the position meets the  $\pm 40\%$  “substantial authority” standard, disclosure of the position is adequate if the tax return preparer advises the taxpayer (“has a conversation with the client”) of all of the penalty standards applicable to the taxpayer under §6662. The tax preparer must also contemporaneously document the advice in the client’s file (§1.6694-2(c)(3)(i)(C)).

**Comment:** With Congress reducing the MLTN standard to the  $\pm 40\%$  “substantial authority” standard, the big speech doesn’t make a lot of sense.

**Comment:** If a client is audited, the contemporaneous documentation requirement shows what the tax preparer was concerned about on the client’s return! What IRS agent will not request this information!

4. **The big speech is required even when the compliance provisions do not require other miscellaneous disclosure forms to be attached to the return.** For tax returns or claims for refund that are subject to penalties other than the accuracy-related penalty for substantial understatements, the tax return preparer must advise the taxpayer of the applicable §6662 penalty standards. This rule is intended to address the situation when the penalty standard applicable to the taxpayer is based on compliance with requirements other than disclosure on the return (for example, the §6662(e) substantial valuation misstatement). In order to establish that the tax return preparer's disclosure obligation was satisfied, the tax return preparer must document contemporaneously in the tax return preparer's files that the information or advice required by the proposed regulations was provided (§1.6694-2(c)(3)(i)(E)).

5. **The big speech +2 if a tax shelter...and be able to prove it.** For income tax returns, if the position is considered a tax shelter or a reportable transaction, disclosure of the position is adequate if the tax return preparer advises the taxpayer that (1) there needs to be, at a minimum, a  $\pm 40\%$  “substantial authority” for the position, (2) the taxpayer possesses a “reasonable belief that the tax treatment was “more likely than not” the proper treatment, and (3) the taxpayer knows that disclosure will not protect the taxpayer from assessment of an accuracy-related penalty. The tax preparer must also contemporaneously document the advice in the client’s file (§1.6694-2(c)(3)(i)(D)).

**Comment:** This requirement doesn’t make a lot of sense after the repeal of the MLTN standards for preparers, but not for tax shelters.

**Adequate disclosure rules for nonsigning tax return preparers.** In the case of a nonsigning tax return preparer, the position may be disclosed in one of three ways:

1. **Return filed with Form 8275/Form 8275-R.** The position may be disclosed on a properly completed and filed [Form 8275](#), Disclosure Statement ([also see instructions](#)), [or Form 8275-R](#), Regulation Disclosure Statement ([also see instructions](#)), as appropriate, or on the tax return in accordance with an IRS annual revenue procedure (e.g., [Rev. Proc. 2008-14](#))

- [§1.6694-2(c)(3)(ii)].
2. **Lecture the taxpayer...and be able to prove it.** A nonsigning tax return preparer may meet the disclosure standards if the nonsigning tax return preparer advises the taxpayer of any opportunities to avoid penalties under §6662 that could apply to the position and advises the taxpayer of the standards for disclosure to the extent applicable. Strangely, the signing tax preparer must also contemporaneously document that this advice was given to the taxpayer in the signing tax return preparer's client file (§1.6694-2(c)(3)(ii)(A)).
  3. **Lecture the client's tax preparer...and make sure the preparer can prove it!** Disclosure of a position is adequate if a nonsigning tax return preparer advises another tax return preparer that disclosure under §6694(a) may be required. The nonsigning tax return preparer must document contemporaneously in the tax return preparer's files that this advice was provided in the signing tax return preparer's files (§1.6694-2(c)(3)(ii)(B)).

***Each line item must have custom-prepared "contemporaneously document" proof for each client!*** In order to satisfy the disclosure standards when the position is not disclosed on or with the return, ***each return position*** for which there is a "reasonable basis" but for which the tax return preparer does not have "substantial authority" must be addressed by the tax return preparer. Thus, the advice to the taxpayer with respect to each position must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances. No general boilerplate disclaimer or form will satisfy these standards (§1.6694-2(c)(3)(iii)).

Disclosure in the case of items attributable to a passthrough entity is adequate if made at the entity level (see §1.6662-4(f)(5)). For example, a tax return preparer of a partnership tax return need only advise the partnership (PR §1.6694-2(c)(iv)).

**Exception for reasonable cause and good faith.** The penalty under §6694 will not be imposed if, considering all the facts and circumstances, it is determined that there was reasonable cause for the understatement and that the tax preparer acted in good faith (§6694(a); PR §1.6694-2(d)). In any proceeding, the preparer has the burden of proving reasonable cause and good faith, including proof of adequate disclosure (PR §1.6694-2(e)). The six factors used to determine reasonable cause and good faith include:

1. ***Nature of the error.*** Whether the error causing the understatement resulted from a provision that was so complex, uncommon, or highly technical that a competent preparer reasonably could have made the error. The reasonable cause exception *does not apply to an error that would have been apparent from a general review of the return* or refund claim by the preparer (PR §1.6694-2(d)(1)).
2. ***Frequency of errors.*** Whether the understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors. Although the reasonable cause exception generally applies to an isolated error, it *does not apply if the isolated error is so obvious, flagrant or material that it should have been discovered during a review of the return* or claim or *if a pattern of errors exist* (PR §1.6694-2(d)(2)).
3. ***Materiality of errors.*** Whether the understatement was material in relation to the correct tax liability. The reasonable cause exception generally applies if the understatement is of a relatively immaterial amount. However, *even an immaterial understatement may not qualify for the reasonable cause exception if the error or errors creating the understatement are sufficiently*

- obvious or numerous* (PR §1.6694-2(d)(3)).
4. ***Preparer's normal office practice.*** Whether the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error in question would rarely occur and *the normal office practice was followed in preparing the return* or claim in question. Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims for refund and generally would include checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. This relief does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund (PR §1.6694-2(d)(4)).
  5. ***Reliance on advice of others.*** Whether the tax return preparer reasonably relied without verification on the advice of, or schedules or other documents prepared by, the taxpayer, another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), and who the tax return preparer had reason to believe was competent to render the advice or other information. The advice or information may be written or oral, but in either case the burden of establishing that the advice or information was received is on the tax return preparer. A tax return preparer is not considered to have relied in good faith if (a) the advice or information is unreasonable on its face; (b) the tax return preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or; (c) the tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given (PR §1.6694-2(d)(5)).
  6. ***Reliance on generally accepted administrative or industry practice.*** Whether the tax return preparer reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement. A tax return preparer is not considered to have relied in good faith if the tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed (PR §1.6694-2(d)(6)).