M&G OFFICE RESOURCE & MANAGEMENT, INC.

December 15, 2008

I hope this Newsletter finds you well. With the Presidential Election over, we can now look forward to the holidays and yes yearend Tax Planning.

I have enclosed a copy of the Bail Out Bill for your perusal. I will also try to highlight some areas of interest.

Tax Aspects of Foreclosure and Debt Forgiveness. Attached

If You Didn't File for a Stimulus Payment

If you didn't file for an economic stimulus payment in 2008 because you weren't sure you were eligible, you may be able to file for a payment in 2009. Find out more if you:

- Receive Social Security retirement or disability benefits
- Receive Veterans Affairs pension, disability or survivor's benefits
- Receive Tier 1 Railroad Retirement benefits
- Are a low-wage worker
- Had a child in 2008, additional stimulus may be available

IRS Announces 2008 Standard Mileage Rates; Rate for Business Miles Set at 50.5 Cents per Mile

Beginning Jan. 1, 2008, the standard mileage rates for the use of a car (including vans, pickups or panel trucks) will be:

- 50.5 cents per mile for business miles driven;
- 19 cents per mile driven for medical or moving purposes; and
- 14 cents per mile driven in service of charitable organizations.

What is the AMT? The AMT came into being with the Tax Reform Act of 1969. Its purpose was to target a small number of high-income taxpayers who could claim so many deductions they owed little or no income tax. A growing number of middle-income taxpayers are discovering they are subject to the AMT.

Individual provisions include AMT relief of several kinds. First, there are the exemption amounts for 2008 . . . up to $69,950 for a married couple and $46,200 for a single taxpayer.

Those amounts are slightly higher than 2007, but the $150,000 "phase-out" threshold is unchanged. In addition, a variety of non-refundable credits are permitted to offset an AMT liability, and up to 50% of long-term unused credits can offset an AMT liability.

AMT exemption amount for a child increased. The AMT exemption amount for a child whose unearned income is taxed at the parent's tax rate has increased to $6,400.

Certain credits no longer allowed against the AMT. The credit for child and dependent care expenses, credit for the elderly or the disabled, education credits, residential energy credits, mortgage interest credit, and the District of Columbia first-time homebuyer credit are no longer allowed against the AMT, and a new tax liability limit applies. This limit is your regular tax minus any tentative minimum tax (figured without any AMT foreign tax credit).

Other Topics:

Alimony Recapture Rules – New Worksheet

2008 Heroes Tax Act: Retirement Savings: Allows "rollover" of military death gratuities or Service members Group Life Insurance Proceeds to a Roth IRA

Tax –Related Identity Theft

On-line Payment Agreement (OPA) – New tool to pay online

Independent Contractor versus Employee reclassification audits and Section 530 Relief –Safe Harbor

Employee Stock Options: Employer reporting of incentive stock option exercise will start in 2008

Conversions to Roth IRA: New Law Beginning in 2010, the AGI limitation for converting IRA accounts to Roth accounts will be eliminated. In addition, for conversions done during 2010, the taxable amounts (and taxes paid) may be reported one-half in each 2011 and 2012. The taxpayer may elect to report the entire amount in 2010, the year of conversion.

Alternative Motor Vehicle Credit

Vehicles Purchased or Placed in Service

The Energy Policy Act of 2005 replaced the clean-fuel burning deduction with a tax credit. A tax credit is subtracted directly from the total amount of federal tax owed, thus reducing or even eliminating the taxpayer's tax obligation. The tax credit for hybrid vehicles applies to vehicles purchased or placed in service on or after January 1, 2006.

The credit is only available to the original purchaser of a new, qualifying vehicle. If a qualifying vehicle is leased to a consumer, the leasing company may claim the credit.

Energy and conservation credits extended include:

1. $500 residential energy credit reinstated for 2009 only
2. Residential alternative energy credit extended through 2016 and expanded to 30% of expenditures
3. A new credit for "qualified plug-in electric drive" motor vehicles of $2,500 plus an additional amount based on weight of the vehicle . . . available through 2014
4. Credits for alternative fuel vehicle refueling property and for renewable electricity production extended through 2010
5. Energy investment credit for solar, micro-turbine, and qualified fuel cell increased and extended through 12/31/16
6. Energy efficient homes credit extended through 12/31/09 and energy appliance credit through 2010
7. 50% bonus depreciation is allowed for reuse and recycling property placed in service after 8/31/08
8. There are several other energy credits of very limited application that are extended as well.

PPC

National Tax Advisory®

TO: All Professional Tax Personnel
FROM: William R. Bischoff, CPA

NTA-682
DATE: October 21, 2008

RE: **Bailout Bill Includes Tons of Tax Changes**

Background

The massive Emergency Economic Stabilization Act of 2008 (the Act) was signed into law on 10/3/08. The new law, better known as the bailout bill, includes over 100 federal tax changes (depending on how you count). We will summarize the ones we think are the most important here. By necessity, our discussion will often be very brief. Let's start with the changes that affect individual taxpayers.

Changes Affecting Individuals

Another One-year AMT Patch. As in prior years, this year's AMT patch has two parts. These changes only apply to tax years beginning in 2008, which means calendar-year 2008 for almost all individual taxpayers.

Bigger AMT Exemptions. The Act grants higher AMT exemptions for tax years beginning in 2008. The new exemption amounts are [IRC Sec. 55(d)(1)]:

- $69,950 for married joint filers and surviving spouses (up from $66,250 for 2007).
- $46,200 for unmarried individuals (up from $44,350 for 2007).
- $34,975 for married individuals who file separately (up from $33,125 for 2007).

Certain Nonrefundable Tax Credits Can Offset AMT Liabilities. The Act permits individuals to use designated nonrefundable personal tax credits to reduce their AMT liabilities, as well as their regular tax liabilities for tax years beginning in 2008. (The same deal applied for 2007.) This favorable provision applies to the following personal credits. [IRC Sec. 26(a)(2)]:

- Child tax credit of up to $1,000 per qualifying child (IRC Sec. 24).
- Hope Scholarship credit of up to $1,800 (IRC Sec. 25A).
- Lifetime Learning credit of up to $2,000 (IRC Sec. 25A).
- Dependent care credit (IRC Sec 21).
- Adoption credit (IRC Sec. 23).
- Retirement saver's credit (IRC Sec. 25B).

- Credit for certain energy-efficient improvements to a U.S. principal residence (IRC Sec. 25C) and credit for certain solar and fuel cell equipment added to a U.S. residence (IRC Sec. 25D).

- Credit for the elderly and disabled (IRC Sec. 22).

- Mortgage tax credit (IRC Sec. 25).

- First-time DC homebuyer tax credit (IRC Sec. 1400C).

Observation: This two-part AMT patch greatly reduces the exposure of individual taxpayers to the dreaded AMT for one more year. However, Congress probably will have to run the same drill all over again to keep millions of additional taxpayers from getting hit with the AMT for 2009.

Extension of Personal Tax Breaks. The Act also resurrects and/or extends the following personal federal income tax breaks:

- *College Tuition Deduction.* The above-the-line deduction for up to $4,000 of college tuition and related fees, under IRC Sec. 222, was retroactively restored for 2008 and extended through 2009.

- *Optional Sales Tax Deduction.* The optional itemized deduction for general state and local sales taxes (which can be claimed in lieu of deducting state and local income taxes), under IRC Sec. 164(b)(5), was retroactively restored for 2008 and extended through 2009.

- *Additional Standard Deduction for Property Taxes.* The new standard deduction add-on for state and local real property taxes paid by individuals who don't itemize, under IRC Sec. 63(c)(1)(C), was extended through 2009. This provision allows married joint-filing couples to deduct up to $1,000 of real property taxes paid during the year. Other taxpayers can deduct up to $500. However, the deduction cannot exceed the actual amount of real property taxes paid during the year. This deduction was established by the Housing Assistance Tax Act of 2008 (enacted on 7/30/08) and was originally intended to be a one-year deal for 2008 only. It now looks like it will be added to the list of "extenders."

- *Educator Expense Deduction.* The above-the-line deduction for up to $250 of personal expenditures by teachers and other school employees to provide items needed for their schools, under IRC Sec. 62(a)(2)(D), was retroactively restored for 2008 and extended through 2009.

- *Tax-free Principal Residence Mortgage Debt Relief.* The provision allowing federal-income-tax-free treatment for up to $2 million of forgiven principal residence mortgage debt, under IRC Sec. 108(a)(1)(E), was extended for three more years through 2012. Taxpayers need not be bankrupt or insolvent to benefit from this provision, which is now available for qualifying debt forgiveness transactions that occur in 2007–2012.

- *IRA Qualified Charitable Distribution Privilege.* The opportunity to use IRA money for charitable donations of up to $100,000 annually, by making so-called qualified charitable distributions (QCDs), was retroactively restored for 2008 and extended through 2009. [See IRC Sec. 408(d)(8)(F).] The QCD privilege is only allowed to IRA owners who have reached age 70½ by the end of the applicable year (2008 or 2009). QCDs are federal-income-tax-free, and no deduction is allowed for them. So they have no direct effect on the donor's taxable income. However, QCDs count as distributions for purposes of meeting the annual required minimum distribution rules that apply to traditional IRAs. So with the QCD deal, taxes can be avoided on amounts that would have otherwise been treated as taxable required minimum distributions.

- *Credit for Residential Solar and Fuel Cell Equipment.* The credit for 30% of expenditures for solar electricity generation, solar water heating equipment, and fuel cell equipment in a U.S. residence, under IRC Sec. 25D, was scheduled to expire at the end of 2008. The Act extends the Section 25D credit through 2016 with modifications—some of which apply for 2008.

1. *The Annual Cap Changes.* For 2008 and earlier years, the maximum annual credit for solar electricity generation equipment is $2,000. For 2008 and earlier years, the maximum annual credit for solar water heating equipment is also $2,000. For fuel cell equipment, the maximum annual credit for 2008 and earlier years is $500 per half kilowatt hour of capacity.

   For 2009–2016, the $2,000 annual cap on the credit for solar electricity generation equipment is removed. However, the $2,000 annual cap on the credit for solar water heating equipment still applies for 2009–2016. Similarly, the $500 annual cap on the fuel cell credit (per half kilowatt hour of capacity) also still applies for 2009–2016.

2. *Additional Equipment Qualifies.* For 2008–2016, 30% of expenditures for small wind energy equipment and geothermal heat pumps can also qualify for the Section 25D credit (subject to annual dollar caps).

3. *AMT Offset Allowed.* Finally, for 2008–2016, the Section 25D credit is allowed to offset both regular tax and AMT liabilities.

- Credit *for Residential Energy-efficient Improvements.* The separate credit for energy-efficient insulation, windows, doors, roofs, and heating and cooling equipment installed in a U.S. residence, under IRC Sec. 25C, expired at the end of 2007. The Act restores the Section 25C credit for 2009, with some modifications. However, the credit is still not available for 2008. Note that the Section 25C credit is limited to only $500 over a taxpayer's lifetime, so it's not terribly significant.

- *First-time DC Homebuyer's Credit.* This credit, under IRC Sec. 1400C, was retroactively restored for 2008 and extended through 2009.

Bigger Refundable Child Tax Credits. For lower-income taxpayers, the IRC Section 24 tax credit of $1,000 per qualifying child can be a refundable credit. [See IRC Sec. 24(d).] Refundable means the taxpayer can collect all or part of any leftover credit after his or her federal income tax liability has been reduced to zero. The refundable amount is generally limited to the lesser of: (1) 15% of the taxpayer's earned income in excess of a threshold or (2) the amount of credit left over after the taxpayer's federal income tax bill is reduced to zero. The Act lowers the 2008 earned income threshold from $12,050 to $8,500. As you can see, the lower threshold can translate into bigger refundable amounts for some taxpayers. This favorable change is for 2008 only.

Refundable AMT Credit Rules Vastly Improved. As we explained in TAM-1274[1] (dated 3/4/08), the refundable AMT credit is available to eligible individuals for 2007–2012 (assuming they are calendar-year taxpayers). The refundable AMT credit rules are intended to allow folks with unused AMT credits that were generated more than three years before the current year (so-called long-term unused AMT credits, which were typically generated by exercising lucrative ISOs) to use some or all of those credits to fully offset the current year's federal income tax liability (both the regular tax part and the AMT part). Any remaining refundable AMT credit amount allowed for the current year could be collected in cash. Sounds great!

Unfortunately, the "old" refundable AMT credit rules (which applied for tax years beginning in 2007) were actually way too restrictive. Under the old rules, it could take up to five years to convert a large long-term unused AMT credit into refundable amounts. For higher-income taxpayers, it could take longer (perhaps forever) because the refundable amount that was otherwise allowed for each year could be partially or completely phased out (using the same phase-out range that applied to personal exemption deductions for that year).

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1 A copy of this article has been placed on PPC's website for the benefit of those who were not subscribers when it was originally published. To retrieve or view the article, go to **http://ppc.thomson.com/subscriptions/tabn**. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Articles Mentioned in Previous Issues."

Thankfully, the Act makes huge improvements in the refundable AMT credit rules. [See IRC Sec. 53(e).] However, the taxpayer-friendly "new" rules only apply to tax years beginning after 2007 (2008–2012 for calendar-year taxpayers). In other words, the bad old rules still apply for 2007 (for calendar-year individuals) while the good new rules apply for 2008–2012.

Specifically, the new rules have the same basic structure as the old rules. However, the new rules delete the unfavorable phase-out provision for higher-income taxpayers. The new rules also make a super-beneficial change to the refundable credit annual limitation calculation. For 2008–2012, the refundable amount for the current year equals the *greater* of: (1) 50% of the long-term unused AMT credit carried into that year or (2) the full amount of the refundable credit for the preceding year (not to exceed the full amount of the long-term unused credit carried into the current year). The following example illustrates how the new annual limitation calculation works.

> **Example 1:** Your client, Chuck, was victimized by the AMT in 2004 when he exercised some lucrative ISOs and generated a $150,000 AMT credit. For simplicity, assume Chuck has never been able to use any of that credit, nor did he generate any AMT credits in any other years. Therefore, Chuck carries a whopping $150,000 long-term unused AMT credit into 2008 (from 2004, which is more than three years prior to 2008). Under the new rules, Chuck's refundable AMT credit for 2008 is a cool $75,000 (.50 x $150,000 carried into 2008). He can collect the entire $75,000 simply by filing his 2008 Form 1040 and including a filled-out Form 8801.
>
> Chuck's long-term unused AMT credit carried into 2009 will be $75,000 (the amount left over from 2008). His refundable AMT credit for 2009 will be $75,000 (same as the 2008 refundable amount, which is also the same as the amount carried into 2009 under the particular facts in this example). Chuck can collect the entire $75,000 by filing his 2009 Form 1040 and including a filled-out Form 8801.
>
> As you can see, the new rules allow the taxpayer to collect a static amount of long-term unused AMT credit over a two-year period. Under the old rules, it could have taken some taxpayers five years or longer to collect large unused long-term credits (maybe much longer if they were affected by the dreaded phase-out rule).

Observation: Not everyone will come out ahead under the new rules. Under the old rules, the entire amount of a long-term unused AMT credit of $5,000 or less could be collected in one year (assuming the phase-out rule did not prevent this). Under the new rules, it takes two years to cash in—even for amounts of $5,000 or less.

Abatement of Unpaid AMT Liabilities, Interest, and Penalties from Pre-2008 ISO Exercises. The Act abates unpaid AMT liabilities, interest, and penalties triggered by exercising ISOs in tax years beginning before 2008. This ultra-favorable abatement rule applies to unpaid amounts that were outstanding on the 10/3/08 date of enactment. [See IRC Sec. 53(f)(1).]

AMT Credits Increased by Paid Interest and Penalties on Unpaid AMT Liabilities from Pre-2008 ISO Exercises. If the taxpayer paid interest and penalties on AMT liabilities triggered by pre-2008 ISO exercises before the 10/3/08 date of enactment, these paid amounts can be recovered in 2008 and 2009, in the form of increased refundable AMT credits. Specifically, the taxpayer's 2008 refundable AMT credit is increased by 50% of the amount of such interest and penalty payments, and the 2009 refundable AMT credit is increased by the remaining 50%.

Of course, some taxpayers can use up their AMT credits without having to mess with the refundable AMT credit rules. For these taxpayers, the AMT credit carried into 2008 is increased by 50% of the amount of paid interest and penalties, and the AMT credit carried into 2009 is increased by the remaining 50%. [See IRC Sec. 53(f)(2).]

Observation: One way or the other, taxpayers can, over a two-year period, recover interest and penalty payments attributable to unpaid AMT liabilities caused by pre-2008 ISO exercises.

Personal Casualty Loss Deductible Increased for 2009 Only. For federal income tax write-off purposes, personal casualty and theft losses must first be reduced by $100 for each casualty or theft event. In effect, this is like a $100 deductible. The total amount of losses remaining for the year after applying the deductible rule is then reduced by 10% of AGI for that year. Any amount left after these reductions can be claimed as an itemized deduction on Schedule A of Form 1040. In a puzzling change, the Act increases the $100 per-event deductible to $500, but only for tax years beginning in 2009. After that, the longstanding $100 per-event deductible will once again apply. Go figure. [See IRC Sec. 165(h)(1).]

Arcane Mutual Fund Rules Extended. The Act extends some specialized tax rules dealing with regulated investment companies (RICs), which are better known as mutual funds, through tax years beginning in 2009. These rules can potentially affect some individual taxpayers. The Act preserves the existing federal income tax treatment of interest-related dividends and short-term capital gains dividends issued by RICs to nonresident alien individuals, the existing federal estate tax treatment of RIC shares owned by nonresident noncitizens, and the existing federal income tax treatment of gains or losses from RIC shares held by nonresident alien individuals and foreign corporations. [See IRC Secs. 871(k), 2105(d), and 897(h).]

Changes Affecting Business

FUTA Tax Surcharge Extended through 2008. The Federal Unemployment Tax Act (FUTA) generally imposes a 6.2% tax rate on the first $7,000 of annual wages paid to each employee. The 6.2% FUTA tax rate is actually composed of a permanent 6% rate plus a .2% "temporary" surtax. The Act extends the .2% surtax through the end of 2009 (maybe it's not so temporary after all). Therefore, the combined FUTA tax rate will continue to be 6.2% through the end of 2009. (See IRC Sec. 3301.)

15-Year Depreciation Provision for Leasehold Improvements and Restaurants Extended. The 15-year straight-line depreciation privilege for qualified leasehold improvements and qualified restaurant building improvements is retroactively restored for property placed in service in 2008 and extended for property placed in service in 2009. In addition, some changes were made for 2009. [See IRC Sec. 168(e)(3)(E).]

The definition of restaurant building improvements is liberalized to allow 15-year depreciation for improvements placed in service in 2009 in buildings that have been in use for three years or less. In addition, eligibility for the 15-year depreciation rule was expanded to cover qualified restaurant buildings themselves (as opposed to building improvements) that are placed in service in 2009. [See IRC Sec. 168(e)(7).] Restaurant improvements and buildings that are eligible for 15-year depreciation under the revised rules applicable to property placed in service in 2009 are not eligible for first-year bonus depreciation. [See IRC Sec. 168(e)(7)(B).] However, under the current bonus depreciation rules, assets placed in service in 2009 are usually ineligible anyway.

Observation: Without the favorable 15-year depreciation rule, leasehold improvements, restaurant building improvements, and restaurant buildings generally must be depreciated straight-line over 39 years.

New 15-year Depreciation Provision for Retail Space Improvements. The Act includes a new provision that allows 15-year straight-line depreciation for qualified retail improvement property placed in service in 2009. [See IRC Sec. 168(e)(3)(E)(ix).] Qualified retail improvement property is defined as any real property improvement to the interior portion of a nonresidential building if: (1) that portion is open to the general public and is used in a retail business of selling tangible personal property to the general public, and (2) the improvement is placed in service more than three years after the date the building was first placed in service.

However, qualified retail improvement property does not include improvements related to: (1) enlarging the building, (2) an elevator or escalator, (3) a structural component that benefits a common area, or (4) the internal structural framework of the building. Finally, qualified retail improvement property is ineligible for first-year depreciation. [See IRC Sec. 168(e)(8).] However, under the current bonus depreciation rules, assets placed in service in 2009 are usually ineligible anyway.

New Five-year Depreciation Provision for Farm Equipment. Before the Act, most types of machinery and equipment used in farming were given a seven-year MACRS recovery period. The Act allows a five-year recovery period for qualifying property used in a farming business [as defined in IRC Sec. 263A(e)(4)] if the property is placed in service in 2009. More specifically, to be eligible for the new (but temporary) five-year depreciation rule, the property must be *qualifying farming property*, which is defined as property that meets the following requirements. [See IRC Sec. 168(e)(3)(B)(vii).]

1. The original use of the property must begin with the taxpayer after 12/31/08 (in other words, the property must be new rather than used).

2. The property must be placed in service by 12/31/09.

3. The property cannot be a grain bin, cotton ginning asset, fence, or other land improvement.

Depreciable property used in a farming business that could otherwise be depreciated using the 200% DB method must be depreciated using the 150% DB method. [See IRC Sec. 168(b)(2)(B).] The 150% DB rule applies equally to qualifying farming property that is depreciated under the new five-year recovery period privilege.

Note: If the taxpayer is required to use or elects to use the ADS method to depreciate qualifying farming property, that property is still considered to have a 10-year class life for ADS purposes (as was the case before the Act).

Ordinary Gain/Loss Treatment for Financial Institution Sales of Fannie Mae and Freddie Mac Preferred Shares. The Act provides that gains and losses recognized by applicable financial institutions from selling or exchanging applicable preferred stock will be treated as ordinary gains and losses. For this purpose, applicable financial institutions generally include (among others) banks, savings and loans, business development corporations, and bank and savings and loan holding companies.

Applicable preferred stock generally means preferred shares in Fannie Mae or Freddie Mac that: (1) were held by an applicable financial institution on 9/6/08 or (2) were sold or exchanged by an applicable financial institution between 1/1/08 and 9/6/08. (To prevent gamesmanship, the definition of applicable financial institution is different for shares sold between 1/1/08 and 9/6/08 and for shares sold after 9/6/08.)

The IRS has authority to extend ordinary gain/loss treatment to other instruments that don't exactly meet the definition of applicable preferred stock, such as pass-through trust certificates (based on sliced and diced portions of Fanny Mae and Freddie Mac preferred stock) held by financial institutions. (See IRC Sec. 1221 and Section 301 of Division A of the Act.)

Research Credit Extended and Modified. The Act retroactively restores for 2008 and extends through 2009, the IRC Section 41 research tax credit for qualifying expenses paid or incurred in those years. In addition, the election to claim the alternative incremental research credit is deleted for tax years beginning after 2008, and the alterative simplified research credit rate is increased to 14% for tax years ending after 2008. Some technical corrections are made as well. (See IRC Sec. 41.) Conforming changes are made to orphan drug credit provisions that make reference to language in the research credit provisions. (See IRC Sec. 45C.)

Enhanced Business Deduction for Food Donations Extended. The Act retroactively restores for 2008 and extends through 2009 the enhanced charitable contribution deduction for non-C corporation businesses that donate food. This provision is intended for non-C corporation businesses that have food inventories, such as restaurants. For non-C corporation taxpayers, deductions for donated food are normally limited to the taxpayer's basis in the food or FMV, whichever is lower. In contrast, the enhanced deduction equals the lesser of: (1) basis plus one-half the value in excess of basis or (2) two times the basis (the same enhanced deduction rule has been available to C corporations for years). To be eligible for the enhanced deduction, the food must be apparently wholesome at the time it is donated. The taxpayer's total charitable contribution deduction for food donations under this provision generally cannot exceed 10% of net income for the tax year from sole proprietorships, S corporations, or partnerships (or other non-C corporation entities) from which the food donations are made. [See IRC Sec. 170(e)(3)(C).]

Note: See immediately following for a special rule for food donations by farmers and ranchers.

Special New Rule for Food Donations by Farmers and Ranchers (12/31/08 Deadline). The Act provides a special new charitable contribution deduction rule for donations of food by qualified farmers and ranchers. To qualify, the food donations must occur between 10/3/08 and 12/31/08. Under the special rule, the maximum charitable contribution deduction limit for such donations is 100% of AGI, over the amount of all other charitable contributions. The amount of food donations in excess of what can be currently deducted can be carried forward for up to 15 years. In the case of charitable food donations by a nonpublicly traded corporation that is a qualified farmer or rancher, the allowable deduction for such contributions can be as much as 100% of the corporation's taxable income (computed before any charitable contribution deductions). The amount of corporate food donations in excess of what can be currently deducted can be carried forward for up to 15 years. To be eligible for the special rule, the food must be apparently wholesome when it is donated. [See new IRC Sec. 170(b)(3).]

Warning: Only food donations made during the period starting on 10/3/08 and ending on 12/31/08 can qualify for this new special rule. So time is of the essence here.

Enhanced C Corporation Deduction for Book Donations Extended. The Act retroactively restores for 2008 and extends through years beginning before 2010 the enhanced deduction for C corporations that donate books to schools. This provision is intended for C corporations that have book inventories, such as publishers and retailers. The enhanced deduction equals the lesser of: (1) basis plus one-half the value in excess of basis or (2) two times the basis. The book donation must be made to a public school that provides elementary or secondary education. However, no enhanced deduction is allowed under this provision unless the school certifies that the contributed books are suitable in terms of currency, content, and quantity for use in its educational programs and will be used for such purpose. [See IRC Sec. 170(e)(3)(D).]

Enhanced C Corporation Deduction for Computer Donations Extended. The Act retroactively restores for 2008 and extends through 2009 the enhanced deduction for C corporations that donate computer equipment and technology to qualifying educational organizations and libraries. The enhanced deduction equals the lesser of: (1) basis plus one-half the value in excess of basis or (2) two times the basis. To be eligible for the enhanced deduction rule, items must be donated within three years after they were acquired new or constructed by the donor. [See IRC Sec. 170(e)(6).]

Special S Corporation Stock Basis Rule to Encourage Appreciated Property Donations Extended. The Act retroactively restores for 2008 and extends through 2009 a special rule for charitable donations by S corporations. Under the special rule, each shareholder's tax basis in his or her shares is only reduced by his or her prorata share of the corporation's tax basis in donated noncash property. In the absence of the special rule, the shareholder's basis reduction would equal his or her prorata share of the passed-through charitable contribution deduction for the donated property. This created an unfavorable result for shareholders when appreciated property (FMV in excess of tax basis) was donated, and the resulting deduction exceeded the property's tax basis. The special rule benefits S corporation shareholders by leaving them with higher tax basis in their stock (higher basis almost never hurts). [See IRC Sec. 1367(a)(2).]

New Tax-free Fringe for Bicycle Commuters. For tax years beginning after 2008, the Act creates a new tax-free transportation fringe benefit for employees who commute to work on bicycles. We kid you not! Under this provision, an employer, can during the 15-month period that begins on the first day of the calendar year, give an employee tax-free reimbursements to cover reasonable expenses incurred during that calendar year to buy, improve, repair, and store a bicycle that is regularly used for commuting between the employee's home and the workplace. However, the amount that can be reimbursed tax-free under this provision is limited to $20 for each month of bicycle commuting. Therefore, the maximum annual tax-free reimbursement is $240. [See IRC Sec. 132(f).]

An employee cannot receive the bicycle commuting fringe benefit for any month that another Section 132(f) tax-free transportation fringe benefit is received from the employer. These other Section 132(f) fringes are employer-provided transit passes, transportation in commuter highway vehicles (better-known as van pooling), and qualified parking. Also, unlike the other Section 132(f) fringes, the new bicycle commuting fringe cannot be provided under a salary reduction arrangement. [See IRC Sec. 132(f)(4).]

Note: For 2009, the estimated maximum monthly amount that can be received tax-free for employer-provided transit passes and van pooling (singly or combined) is $120, and the maximum estimated amount for employer-provided qualified parking is $230. (The IRS has not released the official 2009 figures.)

Changes Affecting Oil and Gas and Refining Businesses

Suspension of Net Income Limitation for Marginal Properties Restored for 2009. The suspension of the 100%-of-net-income limitation on percentage depletion deductions for marginal oil and gas properties is reinstated for tax years beginning in 2009, but not for tax years beginning in 2008. (The suspension had applied for many years before 2008.) Therefore, the net income limitation still applies to marginal properties for tax years beginning in 2008 (bad for taxpayers), but not for tax years beginning in 2009 (good for taxpayers). [See IRC Sec. 613A(c)(6)(H).]

Domestic Producers Deduction Reduced. The Section 199 domestic producers deduction is scheduled to increase from the current 6% to 9% for tax years beginning after 2009. However, the Act reduces the otherwise allowable deduction for those years by 3% of the least of: (1) oil-related qualified production activities income (a broadly defined term), (2) qualified production activities income, or (3) taxable income determined before the Section 199 deduction. As you can see, the intent of this change is to effectively freeze the Section 199 deduction for oil-related income at 6% for tax years beginning after 2009.

For individual taxpayers, the otherwise allowable deduction for tax years beginning after 2009 is reduced by 3% of the least of: (1) oil-related qualified production activities income, (2) qualified production activities income, or (3) modified AGI as defined in IRC Sec. 199(d)(2). [See IRC Sec. 199(d)(9).]

First-year 50% Expensing for Refinery Property Extended and Liberalized. The Act extends the 50% first-year expensing privilege for qualified refinery property in the U.S. for two additional years—to cover property placed in service through 2013. In addition, the deadlines for entering into binding contracts and construction beginning dates are extended for two years (through 12/31/09) to make it easier to qualify for this break. The definition of qualified refinery property is expanded to include property designed primarily to process liquid fuel directly from shale or tar sands. Finally, the processing of shale and tar sands is added to the list of production activities that can be used to help additions to existing refineries meet the definition of qualified refinery property. This last change is effective for property placed in service after 10/3/08. (See IRC Sec. 179C.)

Less Favorable Foreign Tax Credit Rules. The Act makes complicated and generally unfavorable changes in how foreign tax credits are calculated for taxpayers with foreign oil and gas extraction income and foreign oil-related income. These changes are generally effective for tax years beginning after 2008. (See IRC Sec. 907.)

Other Business Extenders and Changes

Seven-year Depreciation for Motorsport Property. The provision allowing qualifying property used for land improvement and support facilities at motorsports entertainment complexes to be treated as seven-year MACRS property is retroactively restored for property placed in service in 2008 and extended for property placed in service in 2009. [See IRC Sec. 168(i)(15)(D).]

Domestic Producers Deduction for Puerto Rico. The rule allowing taxpayers to treat Puerto Rico as part of the U.S. for purposes of calculating the Section 199 domestic producers deduction is retroactively restored for tax years beginning in 2008 and extended through tax years beginning in 2009. [See IRC Sec. 199(d)(8).]

Domestic Producers Deduction for Filmmakers. For purposes of the calculating the Section 199 domestic producers deduction, domestic production gross receipts include receipts from producing qualified films. The Act broadens the definition of qualified films to include copyrights, trademarks, and other intangibles related to films. In addition, the Act broadens the definition of "W-2 wages" for purposes of calculating the 50%-of-W-2-wage limitation on Section 199 deductions for filmmakers. The new definition includes compensation paid for services performed in the U.S. by actors, production personnel, directors, and producers whether in the form of actual W-2 wages or not. Finally, the Act includes technical changes to make it easier for taxpayers to claim Section 199 deductions when filmmaking ventures are conducted via partnership and S corporations. All these changes are retroactively effective for tax years beginning after 2007. (See IRC Sec. 199.)

Expensing Election for Film and TV Productions. The Act extends the election allowing taxpayers to claim current deductions for up to $15 million, or $20 million in some cases, of qualified film and television production costs—to cover productions commencing before 2010. Another change allows the election for productions that cost more than the applicable threshold of either $15 million or $20 million. Before this favorable change, the election privilege was completely lost if the applicable cost threshold was exceeded. This change is effective for productions commencing after 2007 and before 2010 (so it's retroactively effective for productions commencing in 2008). (See IRC Sec. 181.)

Environmental Remediation Expense Deduction. The election allowing taxpayers to elect to deduct qualified environmental remediation expenses for sites designated as contaminated areas by state agencies in the year when they are paid or incurred is retroactively restored for expenses in 2008 and extended for expenses in 2009. (See IRC Sec. 198.)

New Markets Tax Credit. The tax credit for qualified equity investments in certain community development entities is extended through 2009. (See IRC Sec. 45D.)

Subpart F Exception for Active Financing Income. The Act extends the exclusion of active financing income from the definition of Subpart F income for one year—to cover tax years of foreign corporations beginning before 2010 and tax years of U.S. shareholders with or within which such tax years of foreign corporations end. [See IRC Secs. 953(e)(10) and 954(h)(9).]

Look-through Rule for Payments between Related CFCs. The Act extends so-called look-through treatment for payments of dividends, interest, rents, and royalties between related controlled foreign corporations (CFCs) for one year—to cover tax years of foreign corporations beginning before 2010 and tax years of U.S. shareholders with or within which such tax years of foreign corporations end. [See IRC Sec. 954(c)(6)(C).]

Employer Tax Credit for Indian Reservation Employees. The business tax credit for employers of qualified employees that live and work on or near Indian reservations is retroactively restored for tax years beginning in 2008 and extended through tax years beginning in 2009. (See IRC Sec. 45A.)

Depreciation of Indian Reservation Property. The provision allowing shorter depreciation periods for qualified Indian reservation property is retroactively restored for property placed in service in 2008 and extended for property placed in service in 2009. [See IRC Sec. 168(j)(8).]

Railroad Track Maintenance Credit. The tax credit for qualifying expenditures to maintain railroad tracks is retroactively restored for expenses paid or incurred in tax years beginning in 2008 and extended for expenses in tax years beginning in 2009. Another change provides that the credit can be used to reduce the taxpayer's AMT liability, effective for credits generated in tax years beginning after 2007 and carrybacks of such credits. [See IRC Secs 45G and 38(c)(4)(B)(iv).]

Work Opportunity Tax Credit for Katrina Employees. The provision treating Hurricane Katrina employees (as defined) as members of a targeted group for purposes of claiming the work opportunity tax credit is extended for two additional years—to cover qualifying individuals hired through 8/28/09. (See Section 319 of Division C of the Act.)

First-year 50% Expensing for Mine Equipment. The Act extends the 50% first-year expensing privilege for advanced underground mine safety equipment in the U.S. for one year—to cover qualifying property placed in service in 2009. (See IRC Sec. 179E.)

Mine Rescue Training Program Tax Credit. The Act extends the tax credit of up to $10,000 for mine rescue team training programs for one year—to cover tax years beginning in 2009. [See IRC Sec. 45N(e).]

Changes Affecting First-tier Tax Preparer Penalty

In a favorable development, the Act loosens the standard that tax preparers must generally meet to avoid the first-tier IRC Section 6694(a) preparer penalty for tax understatements due to undisclosed positions taken on returns or refund claims. [The first-tier penalty is the greater of: $1,000 or (2) 50% of the income from preparing the return or claim.] Preparers must now meet the "substantial authority" standard rather than the stricter "more-likely-than-not" standard. This beneficial change is retroactively effective for returns or claims prepared after 5/25/07.

Under prior law, tax preparers generally had to meet the more-likely-than-not standard to avoid the first-tier penalty for undisclosed positions while their clients only to meet the looser substantial authority standard to avoid the corresponding IRC Section 6662 substantial understatement penalty on taxpayers. Therefore, preparers might have wanted to disclose controversial positions to avoid penalties on themselves (because the stricter more-likely-than-not standard was not met) while their clients did not want to disclose the same positions (because the looser substantial authority standard was met). This was a bad situation, but the new law retroactively fixes the problem. [See IRC Sec. 6694(a).]

On a less-favorable note, another change provides that disclosing a position relating to a tax shelter (as defined in IRC Sec. 6662) or a reportable transaction (as defined in IRC Sec. 6662A) doesn't avoid the first-tier preparer penalty unless the more-likely-than-not standard is met. This change affects returns prepared for tax years ending after 10/3/08.

As under prior law, disclosed positions that are not related to tax shelters or reportable transactions must still meet the "reasonable basis" standard to avoid preparer and taxpayer penalties. The reasonable basis standard is looser than the substantial authority standard.

Note: The Act doesn't change the rules for the more serious second-tier preparer penalty, under IRC Sec. 6694(b), which applies to tax understatements due to wilful misconduct or reckless and intentional disregard of tax rules or regulations. The second-tier penalty is the greater of: $5,000 or (2) 50% of the income from preparing the return or refund claim.

Changes Affecting Executive Compensation

New Restrictions on Offshore Nonqualified Deferred Compensation Arrangements. The Act creates new IRC Sec. 457A, which is intended to shut down tax deferral benefits for individuals under funded deferred compensation arrangements that utilize offshore entities such as foreign corporations and partnerships. Such arrangements have been used to defer taxes on compensation provided to executives and other high-paid employees. Under the new Section 457A provisions, any amount deferred under an affected entity's nonqualified deferred compensation plan (NQDC plan) will be included in gross income at the time when the service provider's right to the deferred amount is not subject to a substantial risk of forfeiture. For this purpose, the definition of "NQDC plan" is quite broad.

When there is no substantial risk of forfeiture with respect to a service provider's right to a deferred compensation amount that was previously undeterminable, the deferred amount is included in the service provider's gross income when it becomes determinable. In addition, that amount is subject to an interest charge and a 20% penalty tax at that time. The interest charge and the 20% penalty tax must be paid by the service provider, and they are cannot be offset by nonrefundable personal credits.

The new Section 457A rules are generally effective for deferred compensation attributable to services performed after 2008. However, special transitional rules apply to deferred compensation under an affected entity's NQDC plan that is attributable to services performed before 2009. [See new IRC Sec. 457A and new IRC Sec. 26(b)(2)(X).]

Note: The new Section 457A rules are layered on top of all the pre-existing rules for nonqualified deferred compensation arrangements, such as the dreaded Section 409A rules.

New Cap on Deductible Executive Comp for Employers Benefiting from Federal Bailout. The Act amends IRC Sec. 162(m) to put a $500,000 annual cap on deductible compensation paid to a covered executive—which means the chief executive officer (CEO), the chief financial officer (CFO), and the three highest-paid employees other than the CEO and CFO. This new deductible compensation limitation generally applies to an employer after it has sold over $300 million of troubled assets (cumulatively) to the federal government. Potentially affected employers are not limited to publicly traded corporations. For instance, they can be closely held corporations or partnerships.

For purposes of the new $500,000 limitation, compensation is generally defined as otherwise-deductible compensation. Therefore, the new $500,000 cap can apply to so-called performance-based compensation, commissions, and deferred compensation attributable to services performed in affected years. The general effective date for the new $500,000 cap is tax years ending on or after 10/3/08. [See new IRC Sec. 162(m)(5).]

Golden Parachute Rules Apply to Certain Payments by Employers Benefiting from Federal Bailout. The Act amends IRC Sec. 280G to expand the reach of the dreaded golden parachute rules. Under the existing rules, the amount of any excess parachute payment cannot be deducted by the corporate service recipient (generally a publicly traded corporation), and the service provider (generally a highly compensated employee, corporate officer, or director) must pay a 20% penalty tax on the amount—pursuant to IRC Sec. 4999.

The expanded Section 280G rules give the same unfavorable treatment to excess parachute payments that are not covered by the existing rules. However, the expanded rules generally apply to an employer only after it has sold over $300 million of troubled assets (cumulatively) to the federal government, and they only apply to excess parachute payments made to a covered executive—which means the CEO, CFO, and the three highest-paid employees other than the CEO and CFO. Also, the expanded rules only apply to excess parachute payments attributable to a covered executive's involuntary termination or termination due to bankruptcy, receivership, or liquidation. However, the expanded rules are not limited to publicly traded corporations. For instance, they can potentially apply to payments to covered executives by closely held corporations and partnerships.

In summary, termination-related excess parachute payments that are subject to the expanded rules cannot be deducted by the employer, and the recipient covered executive must pay a 20% excise tax. The expanded rules generally apply to excess parachute payments made to covered executives during the period when the Treasury Secretary's authorities under the Act are in effect. [See new IRC Sec. 280G(e).]

Changes Affecting Investors

Brokers Must Report Securities Gain/Loss Information to Customers and IRS (Starting in 2011). Current law requires brokers to provide information returns to customers and copies to the IRS, on Form 1099-B, when customers sell securities. While gross sales proceeds must be reported on Form 1099-B, brokers are not currently required to provide any basis information or gain/loss calculation. The Act includes changes that will require brokers to calculate and report gains and losses and classify them as short-term or long-term. [See IRC Sec. 6045(g).] However, these additional reporting requirements will only apply to specified securities that are acquired on or after the following applicable dates:

- The applicable date for corporate stock shares and mutual fund shares is 1/1/11.

- The applicable date for stocks for which the use of an average basis method is allowed (e.g., mutual fund shares when shares are acquired in several different transactions) is 1/1/12.

- The applicable date for other specified securities (notes, bonds, commodity contracts, and other securities and financial instruments to be designated by the IRS) is 1/1/13.

New reporting requirements will also apply to option transactions, for options acquired on or after 1/1/13. Also, the new rules will require brokers to take the IRC Sec. 1091 wash sale rule into account when a loss sale and a triggering purchase of substantially identical securities are both transacted in the same account.

Note: Once these new reporting rules kick in (e.g., starting in 2011 for corporate stocks), a broker that transfers specified securities to a new broker must supply certain information to the new broker. Presumably, this means basis and acquisition date information. (See new IRC Sec. 6045A.)

Form 1099-B Due Date Moved to February 15. The Act also changes the deadline for furnishing required information returns to customers (i.e., Forms 1099-B) to February 15 of the year following the year during which transactions take place. This change applies to information returns due after 2008. Under prior law, the deadline was January 31. (See IRC Sec. 6045.)

Taxpayers Must Use Separate Account Rule to Determine Basis of Securities for Gain/Loss Purposes (Starting in 2011). In general, for specified securities acquired on or after the applicable dates listed earlier (none of which are earlier than 1/1/11), taxpayers must follow a separate account rule when determining the basis of securities when they are sold, exchanged or otherwise disposed of—using whichever basis convention rule applies under the IRC Section 1012 regulations. For instance, if the FIFO method is used to determine the basis of shares when they are sold, the FIFO basis calculation generally must be made based on the shares held in the account from which the shares are sold. Shares held in accounts with other brokers won't enter into the equation. Special rules apply to mutual fund shares for which an average basis method is allowed and shares acquired under dividend reinvestment plans. [See IRC Sec. 1012(c) and (d).]

Securities Issuers Must Provide Information about How Organizational Actions Affect Basis (Starting in 2011). For organizational transactions that impact the basis of specified securities after the applicable dates listed earlier, securities issuers must supply information about how basis is impacted. For instance, if corporate shares are exchanged in a tax-free reorganization that occurs in 2011, the issuer of the shares must supply information about how to allocate the basis of the shares given up in the deal to the shares received in the deal. This information must be provided in information returns under yet-to-be-issued IRS rules. The deadline for filing required information returns with the IRS is the earlier of: (1) 45 days after the date the organizational action occurs or (2) January 15 of the calendar year after the year during which the action occurs. The same information must be provided in statements given to securities owners and nominees (e.g., brokerage firms) by the January 15 deadline.

However, these information returns and statements are not required if the issuer puts out the required information in a publicly available format under yet-to-be-issued IRS rules. (See new IRC Sec. 6045B and Sec. 6724.)

Changes Affecting Tax-exempt and Tax-credit Bonds, Tax-exempt Organizations, and Excise Taxes

In the interest of brevity, we are basically going to list these changes without much explanation. Here goes.

Tax-exempt and Tax-credit Bonds. The Act:

- Creates new qualified energy conservation tax credit bonds, which can be issued after 10/3/08. (See IRC Sec. 54A and new IRC Sec. 54D.)

- Creates a new category of clean renewable energy tax credit bonds (new CREBs), which can be issued after 10/3/08. (See IRC Sec. 54A and new IRC Sec. 54C.)

- Extends the authority to issue the original category of clean renewable energy tax credit bonds (old CREBs) for one additional year to cover bonds issued through 2009. (See IRC Sec. 54.)

- Retroactively restores the increased annual bond issuance limit for tax-exempt DC Zone enterprise facility bonds for 2008 and extends it through 2009. (See IRC Sec. 1400A.)

- Allows tax-exempt bonds to be issued through 2012 to finance the construction and rehabilitation of property damaged or destroyed by Hurricane Ike. (See IRC Sec. 1400N.)

- Allows tax-exempt mortgage bonds to be issued to provide financing to a borrower whose home is destroyed or damaged in a federally declared disaster area in 2008 or 2009, even if the borrower doesn't meet the definition of a first-time homebuyer. In addition, the restriction on home values is relaxed, and some other technical changes are made. [See IRC Sec. 143(k).]

- Extends tax-exempt status for qualified green building and sustainable design project bonds for three additional years to cover bonds issued through 10/1/12. [See IRC Sec. 142(l).]

- Allows the issuance of additional tax credit Qualified Zone Academy Bonds (QZABs) in 2008 and 2009 to finance certain public school projects and programs in low-income areas. The Act also makes significant changes to the QZAB rules for bonds issued after 10/3/08. (See IRC Sec. 54A, and new IRC Sec. 54E.)

Tax-exempt Organizations. The Act:

- Retroactively restores a special unrelated business income tax (UBIT) rule relating to certain payments received by a tax-exempt organization from a controlled entity for 2008 and extends it through 2009. [See IRC Sec. 512(b)(13)(E).]

- Allows the IRS to require exempt organizations to supply information on their annual returns about their disaster-relief efforts and about the amount and use of contributions to which IRC Sec. 1400S applies. (The Section 1400S provisions suspend the normal percentage limitations on deductible charitable contributions in specified circumstances.) This change applies to exempt organization returns due after 2008 (without regard to extensions). [See IRC Sec. 6033(b)(14).]

Excise Taxes. The Act:

- Postpones scheduled reductions in the coal excise tax until as late as 2019 (five additional years). [See IRC Sec. 4121(e)(2).]

- Modifies rules under which coal producers and exporters can claim refunds for excise taxes paid on coal exported or shipped from the U.S. for exports and shipments between 10/1/90 and 10/3/08. (See IRC Secs. 4121, 6416, and 6511.)

- Exempts truck idling reduction units and advanced insulation from the truck retail tax for sales or installations after 10/3/08. [See IRC Sec. 4053(9) and (10).]

- Extends the oil spill liability excise tax for three additional years, through 2017, and increases the tax rate starting in 2009. [See IRC Sec. 4611(f).]

- Retroactively restores for 2008 and extends through 2009 the collection by the U.S. and payment to the treasuries of Puerto Rico and the Virgin Islands the increased excise tax on rum imported from those jurisdictions. [See IRC Sec. 7652(e) and (f)).]

- Exempts wooden arrows designed for practice use by children from the manufacturer's excise tax on arrows, effective for arrows first sold after 10/3/08. [See IRC Sec. 4161(b)(2).]

Miscellaneous Changes

The Act provides that:

- Income from industrial source carbon dioxide and from transporting or storing alcohol fuel, biodiesel rule, and certain other alternative fuels count as qualifying income for purposes of determining if a publicly traded partnership can avoid being taxed as a corporation. This change is effective for tax years ending after 10/3/08. [See IRC Sec. 7701(d)(1)(E).]

- Income received by qualified individual taxpayers from Exxon Valdez litigation is not subject to SE or FICA tax, and it can be averaged over three years, under IRC Sec. 1301, using the same provision that applies to fishermen. In addition, up to $100,000 of such income can be rolled tax-free into an eligible retirement plan. (See Section 504 of Division C of the Act.)

- The American Samoa possessions tax credit for domestic corporations is retroactively restored for tax years beginning in 2008 and extended through tax years beginning in 2009. [See Section 309 of Division C of the Act, which amends Section 119(d) of the Tax Relief and Healthcare Act of 2006.]

- The designation of the District of Columbia Enterprise Zone (DC Zone) is retroactively restored for 2008 and extended through 2009. [See IRC Sec. 1400(f).] This change preserves the ability of qualified taxpayers in the DC Zone to claim enhanced Section 179 deductions (under IRC Sec. 1397A) and empowerment zone employment credits (under IRC Sec. 1396) for two additional years.

- The 0% capital gains tax rate on qualified gains from DC Zone assets is extended for two additional years, through 2014. (See IRC Sec. 1400B).

Energy Related Tax Breaks for Businesses

The Act provides a host of energy related tax breaks for businesses—some are new, while others are an extension of already existing provisions. These provisions are summarized at Appendix 1.

New Tax Breaks for Federally Declared Disaster Areas

The Act introduces a new series of tax breaks for disaster victims, all of which relate to "a Federally declared disaster." This new term, is defined as "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." [See IRC Sec. 165(h)(3)(C).] These provisions are summarized in Appendix 2.

Conclusion

As should be readily apparent by now, this was a huge Act. You now have an overview of what changed. However, by necessity, this release only scratches the surface of all the changes. We'll have more detailed guidance in coming issues where warranted. Finally, TAM-1314 (also in this issue) contains a client letter on this Act.

References:

IRC Secs. 21,22, 23, 24, 25, 25A, 25B, 25D, 26, 30C, 30D, 38, 41, 45A, 45C, 45D, 45G, 45L, 45M, 45N, 48, 53, 54, 54A, 54C, 54D, 54E, 55, 62, 63, 108, 132, 142, 143, 162, 164, 165, 168, 170, 172, 179, 179C, 179E, 181, 198, 199, 222, 280G, 408, 457A, 512, 613A, 871, 897, 907, 953, 954, 1012, 1221, 1367, 1400, 1400A, 1400B, 1400C, 1400N, 2015, 3301, 4053, 4121, 4161, 4611, 6033, 6045, 6416, 6511, 6604, 6662, 6662A, 6724, 7652, and 7701.

Appendix 1

Summary of Business Energy Credits and Deductions

Act Sec.	Code Sec.	Item	Effective Date	New Law	Prior Law
103	48(a)	**Business Energy Credits**	2009–2016	Business energy tax credit for solar energy property, qualified fuel cell property, and microturbine property, are extended. [IRC Sec. 48(a)]	The credits for these properties were scheduled to expire after 2008.
103	38(c)(4)	**Energy Credit—Allowed against AMT**	Tax years beginning after 10/3/08	The Act adds to the list of specified credits allowed against the AMT the investment credit to the extent that the credit is attributable to the energy credit determined under Section 48. [IRC Sec. 38(c)(4)]	Of the general business credits, only "specified credits" can offset 100% of AMT.
104	48(a)(3)	**Small Wind Property Credit**	Property placed in service after 10/3/08 and before 2017	Qualified small wind energy property is added to the list of property eligible for the Section 48 business energy tax credit. Qualified small wind energy property is property used in a trade or business (or for the production of income) that uses a qualifying small wind turbine to generate electricity of not more than 100 kilowatts. The credit is limited to $4,000 per year. [IRC Sec. 48(a)(3)(A)]	No provision.
105	48(a)(3)	**Geothermal Heat Pump Systems Credit**	Property placed in service after 10/3/08 and before 2017	Geothermal heat pump systems are added to the list of property eligible for the Section 48 business energy credit. A geothermal heat pump system is equipment used in a trade or business (or for the production of income) that uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure. [IRC Sec. 48(a)(3)(A)]	No provision.
205	30D	**Plug-in Electric Vehicle Credit**	Vehicles purchased 2009–2014	A tax credit is allowed for plug-in electric vehicles. The credit is $2,500 for vehicles powered by a 4-kilowatt hour battery, with an additional $417 for each kilowatt hour of battery power beyond that, up to a total limit of $7,500 for light-duty vehicles (up to $15,000 for vehicles weighing more than 26,000 pounds). The credit phases out after the 250,000th plug-in electric vehicle has been sold. Business and individuals can claim the credit. Individuals can take it against AMT. (IRC Sec. 30D)	No provision.
207	30C(g)	**Alternative Fuel Vehicle Refueling Property Credit**	2010	The Act extends for one year the credit for installing qualified alternative vehicle refueling property, other than for property relating to hydrogen, which continues through 2014 under present law. In addition, electricity is added to the list of clean-burning fuels for this credit, effective for such property placed in service after 10/3/08. [IRC Sec. 30C(g)]	The credit was scheduled to expire after 2009.

Act Sec.	Code Sec.	Item	Effective Date	New Law	Prior Law
303	179D	**Energy Efficient Commercial Buildings Deduction**	Property placed in service 2009–2013	The Act extends for five years the deduction allowed for the cost of "energy efficient commercial building property" placed in service during the tax year. (IRC Sec. 179D)	The deduction was scheduled to expire for property placed in service after 2008.
304	45L	**Energy Efficient Home Credit**	Qualified homes acquired in 2009	The Act extends for one year (to 2009) the credit (generally up to $2,000) allowed to a contractor for each qualified new energy efficient home that the contractor constructs and which is acquired by 12/31/09 by a person from the contractor for use as a residence. [IRC Sec. 45L(g)]	The credit was scheduled to expire after 2008.
305	45M	**Energy Efficient Appliance Credit**	Appliances produced after 2007	The Act changes the per-item credit amounts and eligibility standards for dishwashers, washing machines and refrigerators. The credit is extended through 2010.	Credit allowed at various amounts prescribed in the Code and scheduled to expire after 2007.

Appendix 2

Summary of Relief Provisions for Federally Declared Disasters

Act Sec.	Code Sec.	Item	Effective Date	New Law	Prior Law
706	165(h) 1033(h)	**Federally Declared Disaster**		The Act replaces the term *Presidentially declared disaster* with the term "federally declared disaster," which means a disaster later determined by the President to warrant federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The "disaster area" is the area determined to warrant assistance. **Note:** The definition is basically the same as before but the now is found in Section 165 rather than Section 1033.	The term "Presidentially declared disaster" was used.
706	165(h)	**Casualty Losses**	2008–2009	The 10%-of-AGI limit on personal casualty losses is waived for net disaster losses (personal casualty losses attributable to federally declared disasters over personal casualty gains). [IRC Sec. 165(h)]	The 10%-of-AGI limit applied to all personal casualty losses.
706	63(c)(1)	**Standard Deduction**	Disasters declared 2008–2009	Nonitemizers can increase their standard deduction by the amount of their disaster loss deduction, which is their personal casualty loss attributable to a federally declared disaster over any personal casualty gains. [IRC Sec. 63(c)(1)]	No provision.
706	165(h)	**Casualty Losses**	2009	Individuals' per-casualty floor for personal-use property is increased from $100 to $500 for 2009. [IRC Sec. 165(h)]	The floor for each personal-use casualty loss is $100.
707	198A	**Qualified Disaster Expenses**	Paid after 2007 for disasters declared after 2007 and before 2010	A taxpayer may elect to deduct qualified disaster expenses, which are expenditures related to a federally declared disaster and that are : 1. Paid or incurred in connection with a trade or business or with business-related property, 2. For any of the following reasons: • Abatement or control of hazardous substances that were released, • Removal of debris from, or the demolition of structures on, damaged or destroyed business-related real property or • Repair of damaged business-related property, and 3. Otherwise chargeable to capital account. (IRC Sec. 198A)	No provision.

Act Sec.	Code Sec.	Item	Effective Date	New Law	Prior Law
708	172(b)	**Net Operating Loss**	Losses attributable to disasters occurring 2008–2009	*Qualified disaster losses* can be carried back five years and are deductible against 100% of AMT income. A "qualified disaster loss" is the lesser of: a. The sum of (a) the casualty losses attributable to a federally declared disaster and (b) the deduction for qualified disaster expenses (or what would be allowable if not otherwise treated as an expense), or b. The NOL for the tax year. [IRC Sec. 172(b)] If the taxpayer elects not to apply the 5-year carryback, the loss is carried back two years [IRC Sec. 172(j).	A three-year carryback is allowed for an "eligible loss," which includes an individual's loss from casualty or theft and a farm or small business loss attributable to designated disasters.
710	168(n)	**Special Depreciation Allowance**	Property placed in service after 2007 for disasters declared after 2007 and occurring before 2010	50% special (bonus) depreciation is allowed on "qualified disaster assistance property" for the year it's placed in service. Such property is not subject to the AMT adjustment for its entire recovery period. *Qualified disaster assistance property*, is property used in an active trade or business that is either: 1. MACRS property with a recovery period of 20 years or less; computer software; water utility property and qualified leasehold improvement property or 2. Nonresidential real property or residential rental property In addition, substantially all of the property's use must be in a federally declared disaster area, the property must replace or rehabilitate property that was damaged or destroyed and its first use in the disaster area must begin with the taxpayer. [IRC Sec. 168(n)]	No provision.
711	179(e)	**Section 179 Expensing**	Property placed in service after 2007 for disasters declared after 2007 and occurring before 2010	The Section 179 deduction limit is increased by the lesser of (a) $100,000 or (b) the cost of qualified Section 179 disaster assistance property placed in service during the tax year. The qualifying property threshold (when deduction begins to phase-out) is increased by the lesser of: (a) $600,000 or (b) the cost of qualified Section 179 disaster assistance property. Qualified Section 179 disaster assistance property is Section 179 property which is qualified disaster assistance property (see above). [IRC Sec. 179(e)]	No provision.

Chapter 6: Tax Aspects of Foreclosure and Debt Forgiveness

Overview

Foreclosures and debt discharges are relatively common for individual taxpayers. This chapter covers the tax implications of debt discharge income and foreclosures.

Learning Objective

Completion of this chapter will enable you to:

- Identify the tax impact of foreclosures and debt discharges

Introduction

Debt cancellation or forgiveness is the result of not paying 100% of a recognized liability. Cancellation or forgiveness of a debt results in gross income for the debtor unless an exception applies, and Revenue Reconciliation Act of 1993 (RRA' 93) adds to the tax relief offered by IRC Sec. 108. The company that is not paid back will issue a 1099 to the client for the amount of debt that is cancelled or forgiven.

The discharged amount includes any amount owed to the lender that is forgiven. This includes loan principal, interest, penalties, administrative costs and fines.

To determine the year in which a debt is discharged, the lender must identify an event indicating the debtor will never have to pay the amount that is discharged. Sometimes the lender will issue a 1099-C for the wrong year.

It is possible the discharge actually occurred in a year closed by the statue of limitations. In this case, the client would not have to recognize the income incorrectly reported in a later year.

A discharge based on a debt settlement agreement that is contingent on some future event generally is deemed to occur on the date the contingencies are satisfied rather than the date the agreement is entered into.

Debt cancellation can occur in various ways, when a client has not paid on a debt and a company cancels or forgives the debt, when the client has transferred property for less than the loan amount, and when the client has renegotiated or received a discount on debt, or the debt has been modified.

Ownership of secured property that is transferred for less than the secured loan amount results in debt cancellation or forgiveness. Foreclosures, short-sales, and repossessions are the most common transfers that a practitioner will encounter.

Debt Discharge Income—Solvent Taxpayer

Cancellation or forgiveness of a debt (other than as a result of a gift) results in gross income for the debtor unless an exception applies. Exceptions include: disputed liabilities, bankruptcy, insolvency, qualified farm debt, qualified real property business debt, a certain type of student loan, a liability which if paid leads to a deduction, seller financing or qualified principal residence indebtedness (see Special Rules for Principal Residence Debt later in this chapter).

Example: Discounted Payoff of Credit Card Debt

Tom and Sue made some purchases using a credit card. As of July 1, 2008, the credit card balance was $30,000. They became delinquent in their payments and a collection company offered them a $10,000 discount if they would pay off the debt. Tom and Sue agreed and paid $20,000 on July 15, 2008.

Impact: The $10,000 principal reduction is recognized as taxable income from debt discharge in 2008 (Rev. Rul. 82-202, 1982-2 CB 35). Because it was a nonbusiness debt, the cancellation of indebtedness income is reported as "Other Income" on line 21 of Form 1040.

Foreclosure and Repossession

Foreclosure and repossession are used to transfer ownership of secured property from the debtor to the secured creditor. Foreclosure is the process used for transferring **real** property, while repossession is the process generally used for transferring **personal** property. Amounts not recovered by the secured creditor may result in collection efforts against the debtor or forgiveness of the debt. If the creditor pursues collection of the debt, then a review of bankruptcy and other alternatives should be made.

Foreclosure—Recourse Debt

A foreclosure or deed in lieu of foreclosure may result in debt discharge income to the borrower. When recourse debt is involved, the taking of the property by the lender is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds the FMV, the excess is treated as debt discharge income if it is forgiven.

Note: See special rule on Special Rules for Principal Residence Debt later in this chapter.

It is possible that a foreclosure involving recourse debt could result in gain or loss on the sale of the property and debt discharge income.

Debt discharge income occurs in a foreclosure only if the lender discharges part or all of any debt deficiency (excess of indebtedness over the property's FMV). If the lender fails to pursue the debt, discharge of indebtedness results when the statute for enforcing the debt expires.

Note: Special rules exist where state law permits a debtor a right of redemption following a foreclosure. In some cases, it is possible for the recognition of gain or loss to be postponed until the end of the redemption period.

Example: Deed in Lieu of Foreclosure

Mitzi could no longer make the monthly payments on her land. The bank agreed that it would take back the land and discharge Mitzi from any further liability on the loan. The facts at the time of the transfer (deed in lieu of foreclosure) were:

Land FMV	$425,000
Land basis	$405,000
Loan Balance	$432,500

Mitzi was not bankrupt or insolvent at the time of the debt discharge. She did not make the special election on qualified real property debt.

Results: Mitzi reports a gain on the transfer (deemed sale) of the land. The sale proceeds of $425,000 equal the lesser of the FMV ($425,000) or debt ($432,500). The reported gain is $20,000 ($425,000 – $405,000). Mitzi also reports debt discharge income of $7,500 ($432,500 – $425,000).

Variation: FMV is less than basis

Assume the same facts as above, except that the FMV at the time of transfer was only $400,000.

Results: Mitzi is treated as having sold the property for $400,000 the lesser of the FMV ($400,000) or loan amount ($432,500). Therefore Mitzi realizes a loss of $5,000 ($400,000 – $405,000). Mitzi has debt discharge income of $32,500 ($432,500 – $400,000). Mitzi should report the debt discharge income as "Other Income" on page 1 of the 1040.

Foreclosure—Nonrecourse Debt

A foreclosure (or deed in lieu of foreclosure) involving nonrecourse debt is treated as a deemed sale by the borrower with proceeds equal to the amount of nonrecourse debt. An abandonment of real property encumbered by nonrecourse financing is also treated as a deemed sale.

The amount realized includes the full amount of the nonrecourse debt. This means there is no debt discharge income due to a foreclosure or deed in lieu transaction involving only nonrecourse debt.

Observation: This tax outcome is unfavorable for insolvent or bankrupt taxpayers who can exclude debt discharge income from gross income. This is because foreclosures satisfying nonrecourse debt may result in nonexcludable gain rather than excludable debt discharge income.

Example

On July 1, 2008, Julie transferred land to the bank in lieu of foreclosure. Although the land had a basis of $320,000, it had decreased to a FMV of $200,000 at the time of transfer. On July 1, 2008, the outstanding balance on the bank loan was $268,000.

Result: Julie has a capital loss of $52,000 ($268,000 – $320,000). There is no debt discharge income because the entire debt was nonrecourse.

Foreclosure and Repossession—Options to Avoid

Both foreclosure and repossession may be avoided by direct discussion and negotiation with the secured creditor. Generally, the debtor has three options available to avoid foreclosure and repossession. Those options are forbearance, modification, and bankruptcy.

It should be noted that the short sale of a secured asset (paying less than owed on the loan) is not a true alternative to foreclosure. A short sale gives the debtor more control over the deficiency owed to the lender. In a short sale, the deficiency is determined by the debtor's ability to negotiate a good sales price. The deficiency will then be collected or forgiven. A short sale is still a negative mark on the debtor's credit report. Plus, as of the writing of this book, mortgage lenders have been less than diligent in differentiating between a short sale and foreclosure. Since both result in a deficiency, the benefits over foreclosure are considered marginal at best.

Forbearance

Forbearance is an agreement between the creditor and debtor as to the amount of payments that may be missed and a payment plan for bringing the payments back on schedule.

Forbearance does not result in forgiven debt since the entire amount of debt to be paid back remains the same. The payment **terms** are the only change of significance.

Modification

A lender, to avoid default, will often modify the terms of a debt in favor of the debtor. This often results in a new loan. Payments missed on the original loan are either absorbed into the new loan without changing the time for payoff or placed onto the back of the loan, thus extending the time for payoff.

A modification must be significant to give rise to forgiven debt income. To determine this, generally all modifications to the debt instrument are considered collectively (when a series of modifications, if considered separately, would not be significant). However, certain modifications listed in Reg. Sec. 1.1001-3(e)(2) through (6) are considered independently. The regulations also provide guidelines for determining whether these independently-considered modifications are significant. The modifications listed in the regulations are [see Reg. Sec. 1.1001-3(e) for details]:

- Changes in the obligation's yield.
- Changes in the timing of payments.
- Changes in the obligor or security.
- Changes in the nature of the debt instrument.
- Changes in customary accounting or financial covenants.

The new (i.e., significantly modified) debt will generate debt forgiveness income if its issue price is less than the balance of the old debt [IRC Sec. 108(e)(10)]. Under the OID rules applicable to nonpublicly traded debt, if the new debt has an interest rate at least equal to the applicable federal rate (AFR), and interest is unconditionally payable at least annually, then the debt's issue price is deemed to be its stated principal amount [IRC Sec. 1274(a)(1)].

Thus, the issuance of new debt (or significant modification of an existing debt) with a principal balance **equal** to the old debt will *not* result in debt discharge income, provided the new (or modified) debt's interest rate equals or exceeds the AFR and interest is paid at least annually. However, if the interest rate is less than the AFR or payments occur less frequently than annually, the issue price is generally the present value of all payments required under the terms of the debt discounted at the AFR, and debt discharge income will result [IRC Sec. 1274(a)(2)].

Example 1: New Debt Issued for Existing Debt; Interest Rate Exceeds AFR

John purchased machinery for his sole proprietorship business on January 1, 2004. He financed the transaction with a $350,000 12% note due in 10 years. Payments were due monthly. The balance as of January 1, 2008 was $257,000. On January 2, 2008, John and the lender agreed to refinance the note at an 8% annual rate. No other terms were modified.

Because the changed loan terms resulted in a significant modification under Reg. Sec. 1.1001-3, the old loan is considered to have been exchanged for a new loan with a term of six years. However, there are no tax consequences to the refinancing since the stated rate of 8% exceeded the January 2008 midterm AFR. Thus, the issue price of the new debt is deemed to be its stated principal amount ($257,000), which was equal to the remaining balance of the old debt.

Example 2: New Debt Issued for Existing Debt; Interest Rate Less Than AFR

Assume the same facts as above except the refinanced rate was 3%. In this case, John will be treated as satisfying the old debt with an amount equal to the imputed principal amount of the new debt, which, for this example, we will assume is $250,000. The difference between the $257,000 stated principal balance and the $250,000 imputed principal amount, or $7,000, is debt discharge income. John reports the $7,000 as income in 2006 unless he is in bankruptcy or insolvent.

Additionally, John is allowed a corresponding OID interest deduction of $7,000. The OID deductions are allocated over the remaining term of the note and can be deducted in the applicable tax years.

Bankruptcy

A bankruptcy filed under Chapter 13 or Chapter 11 of the Bankruptcy Code stops a foreclosure or repossession and allows the debtor to enter into a repayment plan to cure any arrearages on property the debtor desires to keep. Filing a Chapter 7 bankruptcy will result in stalling a foreclosure or repossession and will allow the Debtor to preserve property for longer period of use. However, Chapter 7 bankruptcy does not cure arrearages.

Bankruptcy may stop a foreclosure or repossession if filed prior to the sale date of the foreclosure or repossession.

A bankruptcy attorney should be consulted to determine whether this is in the best financial interest of the client and to make sure all timing issues are addressed correctly.

For further information on the option of bankruptcy, see Chapter 9.

Excluding Discharged Debt from Gross Income

A taxpayer may be able to exclude from gross income certain kinds of debt that has been forgiven or discharged. That type of debt includes:

- Disputed liabilities
- One where the taxpayer is bankrupt
- One where the taxpayer is insolvent
- Certain qualified farm indebtedness
- Certain qualified real property indebtedness
- A certain type of student loan
- A liability, the payment of which generates a deduction
- Seller financing
- Certain qualified principal residence indebtedness

Disputed Liabilities

An exception to the usual treatment of debt discharge income may apply to contested liabilities. If a party demands payment for a liability over which there is a dispute, the eventual agreement to pay a reduced amount may not give rise to debt discharge income. The Third Circuit, in Zarin, found that the Disputed Debt Doctrine applied when the debt's existence was in doubt. The taxpayer incurred gambling debts of over $3,000,000 according to a casino. Eventually, he settled with the casino for $500,000. Because the gambling debt was illegal, and thus, unenforceable, the court found the excess of the original debt over the settlement amount was not taxable income.

It should be noted that the Tenth Circuit has applied the exception differently. There, the Disputed Debt Doctrine applies when the amount, not the existence of the debt, is contested (Preslar). Similarly, in Earnshaw, the taxpayer disputed the amount of interest and late fees added to his credit card balance. When he eventually settled the debt for less than the balance on the credit card company's books, only the amount of the liquidated debt (i.e., the amount fixed by agreement or by the operation of law) in excess of the amount paid was taxable debt discharge income. The cancellation of the disputed charges did not generate debt discharge income.

Bankruptcy

Bankrupt taxpayers may exclude all debt discharge income from taxable gross income under these rules [IRC Sec. 108(a)(1)(A)]. Bankrupt, for this purpose, means the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 (of the U.S Bankruptcy Code) case. Title 11 encompasses the federal bankruptcy statutes and includes Chapters 7 (liquidation), 11 (reorganization), and 13 (small business) bankruptcies.

Example: Kayla's sole proprietorship failed in 2008. She also owns (free and clear) investment land worth $300,000. In November 2008, the bankruptcy judge, in a Chapter 7 case, granted Kayla a discharge from $400,000 in personal debt related to the business. She had had no other assets and liabilities at the time of the discharge.

Kayla can exclude the entire $400,000 because the debt discharge occurred in a Title 11 bankruptcy.

Insolvency

Insolvent taxpayers not under the jurisdiction of a court in a Title 11 case may also exclude debt discharge income from taxable gross income to the extent of insolvency before the debt discharge [IRC Sec. 108(a)(1)(B) and (3)]. Any debt discharge income in excess of insolvency must be included in taxable gross income. For this purpose, insolvency is defined as the excess of the taxpayer's liabilities over the FMV of the taxpayer's assets immediately before the debt discharge [IRC Sec. 108(d)(3)]. When calculating a taxpayer's insolvency, nonrecourse debt is treated as a liability to the extent of the FMV of the property securing the debt. Nonrecourse debt in excess of the property's FMV is treated as a liability to the extent it is discharged (Rev. Rul. 92-53, 1992-2 CB 48).

Example: Taxable Gain with Excludable Discharge Income

Tim's only assets and liabilities relate to his sole proprietorship. Tim owes $500,000 to his bank and has $350,000 in assets.

The bank agrees to reduce the outstanding debt down to $300,000.The debt discharge occurs outside bankruptcy in a voluntary "workout."

Just before the workout, Tim was insolvent by $150,000. Therefore he can exclude $150,000 in debt discharge income. However he must reduce tax attributes by $150,000 as described below. The remaining $50,000 of debt discharge income must be included in Tim's income.

Example: Insolvency and Nonrecourse Debt

In 2005, Annette bought land for $200,000 that was financed by a nonrecourse mortgage for the same amount requiring interest only payments for the first five years.

In 2008, the real estate market crashed dropping the value of the land to $100,000.The lender agreed to reduce the note's balance to $150,000. What are the tax consequences to Annette?

Annette was discharged from $50,000 of debt but will not have to recognize income to the extent she was insolvent immediately before the discharge. The FMV of Annette's assets before the discharge were $200,000 ($100,000 of land and $100,000 of other assets).

Annette's liabilities were $240,000 ($100,000 of nonrecourse financing, included to the extent of the FMV, plus $50,000 in nonrecourse debt in excess of the FMV to the extent discharged, plus $90,000 of other recourse debt).

Therefore, Annette is insolvent to the extent of $40,000 ($200,000 in assets less $240,000 in liabilities). She will recognize $10,000 ($50,000 debt discharged – $40,000 excluded under the insolvency rule) of debt discharge income in 2008.

Property transferred by insolvent debtor – When an insolvent taxpayer's debt is partially discharged and partially satisfied by the transfer of property, the transaction must be bifurcated between the debt discharge and the property disposition. The amount of debt satisfied by the transfer of the property is treated as sales proceeds for the property, from which gain or loss is computed. The separate debt discharge amount is eligible for exclusion under IRC Sec. 108; to the extent the taxpayer is insolvent.

Example

Curtis transfers a vacant lot with a FMV of $30,000 in complete settlement of a $50,000 unsecured loan form the bank. The bank forgives the remaining $20,000 of the loan. Curtis' basis in the lot was $25,000.

The transfer of the lot and the debt discharge are treated as two separate transactions. The lot is considered to be sold at its FMV of $30,000 resulting in a $5,000 taxable gain to Curtis. The $20,000 in debt forgiveness is excluded from gross income under the insolvency rules.

Qualified Farm Debt—Special Rules for Farmers

In addition to bankrupt and insolvent taxpayers, farmers do not have to recognize debt discharge income if the forgiven debt is "qualified farm indebtedness" [IRC Sec. 108(a)(1)(C)]. For this exception, the following conditions must be met [IRC Sec. 108(g)]:

- The debt was incurred directly in the business of farming.
- At least 50% of the taxpayer's gross receipts from all sources, including farming, for the preceding three years were attributable to the business of farming.
- The lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality.

The amount of debt discharge income excludable by farmers is limited to the total of certain tax attributes plus the aggregate bases of business property and property held for the production of income. To the extent the debt discharge exceeds these attributes, income must be recognized.

Example 1: Discharge of Farm Indebtedness

Bill Hayseed has been in the farming business for 10 years. More than 50% of his annual gross receipts are attributable to farming. In 2006, he borrowed $75,000 from a state agricultural agency to be used for farm operating expenses. For several years, he could not meet certain financial obligations, although he was not insolvent or in bankruptcy. In 2008, the state agency discharged the $70,000 remaining balance of its loan to Mr. Hayseed.

The discharge will not result in income to Bill because he meets the Section 108(g) rules for discharge of qualified farm indebtedness. However, assuming Bill has no other tax attributes that can be reduced, he must reduce his tax basis in depreciable business or income-producing property, then reduce his basis in farmland, and finally reduce his basis in other business or income-producing property to the extent of the $70,000 discharged indebtedness. This basis reduction is reported on Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness). Any debt discharge income in excess of these basis reductions is includable in gross income on the "Other income" line of Schedule F of Bill's Form 1040.

Reduction of Tax Attributes—Payback Time

A taxpayer who has excluded debt discharge income either because of bankruptcy, insolvency or qualified farm property indebtedness, must reduce certain tax attributes. This is accomplished by attaching form 982 to the taxpayer's income tax return in the year the discharge was obtained or the property was transferred (IRC Sec. 108 (b)).

Some or all of the excluded debt discharge income is the result of a timing difference. The tax attributes are reduced (dollar for dollar, except for the credits) in the following order [IRC Sec. 108(b)(2)]:

- *Net Operating Losses (NOLs).* Any NOL from the tax year of debt discharge and any NOL carried into that year.
- *General Business Credits.* Any credit carryover to or from the year of discharge. (Credits are reduced by 33⅓ cents for each dollar of excluded debt discharge income.)
- *Minimum Tax Credit as of the Beginning of the Tax Year Immediately Following the Tax Year of Discharge.* (Credits are reduced by 33⅓ cents for each dollar of excluded debt discharge income.)
- *Capital Loss Carryovers.* Any capital loss from the year of discharge, and any capital loss carryover into that year.
- *Basis.* The tax basis of the taxpayer's property under the rules prescribed in IRC Sec. 1017.
- *Passive Activity Loss and Credit Carryovers from the Year of Discharge.* (Reduction for the credit carryover is 33⅓ cents for each dollar of excluded debt discharge income.)
- *Foreign Tax Credits.* Any credit carryover to or from the year of discharge. (Credits are reduced by 33⅓ cents for each dollar of excluded debt discharge income.)

Any tax attributes subject to reduction under IRC Sec. 108(b)(2) that are carryovers to the tax year of the discharge, or that may be carried back to tax years preceding the year of the discharge, are taken into account for the tax year of the discharge or the preceding year, as the case may be, before the attributes are reduced pursuant to IRC Sec. 108(b)(2) [Reg.1-108-7(b)].

Qualified Real Property Business Debt—Special Rules for Real Property Business Debt

A taxpayer who is **not** insolvent or bankrupt can elect to exclude from gross income any income from the discharge of qualified real property business debt [IRC Sec. 108(a)(1)(D)]. Qualified real property business debt includes debt [IRC Sec. 108(c)(3)]:

- that was incurred or assumed in connection with real property used in a trade or business and that is secured by such real property;
- that was incurred or assumed (a) before January 1, 1993, or (b) on or after January 1, 1993 and is qualified acquisition debt (i.e., debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business); and
- with respect to which an election to invoke the special rules of IRC Sec. 108(a)(1)(D) has been made.

Qualified real property business debt does *not* include qualified farm indebtedness but does include debt incurred to refinance qualified real property business debt (to the extent refinancing proceeds do not exceed the principal amount of the qualified real property business debt being refinanced).

Example 1: Determining Qualified Real Property Business Debt

George Camero operates an auto repair shop as a sole proprietor. He purchased a tract of land in 2004 and built his own shop. The cost of the land and building was $200,000, financed by a $25,000 down payment and a $175,000 nonrecourse note obtained from a third-party lender. On July 31, 2006, when the FMV of the land and building was $100,000 and the balance of the note was $150,000, the lender agreed to reduce the principal of the note by $50,000. Since the note is qualified acquisition debt, the debt discharge income is excluded from George's gross income. This assumes George makes the Section 108(a)(1)(D) election.

As previously stated, the debt must be incurred or assumed in connection with a trade or business. This trade or business requirement can be particularly difficult for rental properties to meet and is usually based on the extent of the taxpayer's involvement in the rental activity. In Ltr. Rul. 9426006, the IRS concluded that a taxpayer's involvement was sufficient to constitute a trade or business even though a management company was engaged as the leasing agent and handled day-to-day operations. Rentals conducted as "net leases," however, generally do not qualify as a trade or business (Rev. Rul. 73-522, 1973-2 CB 226).

The taxpayer must make a valid election to exclude income from the discharge of qualified real property business debt [IRC Sec. 108(c)(3)(C)]. This election is made on Form 982 and attached to the taxpayer's income tax return for the tax year the discharge occurs [IRC Sec. 108(d)(9); Reg. 1.108-5].

Limitation on Exclusion – The amount of qualified real property business debt discharge income that can be excluded cannot exceed the lesser of the following [IRC Sec. 108(c)(2); Reg. 1.108-6]:

- *FMV Limitation.* The excess of the outstanding principal amount (immediately before the discharge) over the FMV of the real property securing the debt (reduced by the principal amount of any other qualified real property business debt secured by the property). The outstanding principal amount is the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future.

- *Overall Limitation.* The aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge reduced by depreciation claimed for the year of the excluded debt discharge income.

When applying the overall limitation, the adjusted basis of the taxpayer's depreciable real property must first be reduced by (1) any reduction in basis made under IRC Sec. 108(b) for reductions in tax attributes of a bankrupt or insolvent taxpayer, or (2) any reduction made under IRC Sec. 108(g) for the discharge of qualified farm debt. If depreciable real property is acquired in contemplation of a discharge of qualified real property business debt, the property's basis is not included in applying the overall limitation [IRC Sec. 108(c)(2)(B)].

Example 1: Application of Real Property Business Debt Limitations

Joan Ofarc owns a building used in her business. Its FMV is $150,000 (adjusted basis $175,000). The building secures a first mortgage of $110,000 and a second mortgage of $90,000. None of the debt is qualified farm indebtedness. Joan is not insolvent or bankrupt and owns no other depreciable real property.

On July 1, 2008, the second mortgagee agrees to reduce its debt from $90,000 to $30,000, resulting in debt discharge income of $60,000. The FMV rule limits the total amount of debt discharge income that can be excluded to $50,000, the amount by which the principal of the debt ($90,000) exceeds the FMV of the collateral property, reduced by other qualified real property business debt securing the property ($150,000 − $110,000 = $40,000). Therefore, Joan can exclude $50,000 of debt discharge income if she files an election to do so with her 2008 return. The remaining $10,000 of debt discharge income is included in her 2008 income.

Client Advice: Because the FMV of the secured property plays a key role in determining the amount of excludable debt discharge income, taxpayers will often benefit from an appraisal that minimizes the property's FMV (if more than one appraisal has been obtained from qualified appraisers and one of the appraisals gives heavier weight to factors that would minimize the fair market value of the property—appraising property is not a perfect science and therefore appraisals of the same property by different appraisers may have different results).

Basis Adjustment Requirement: Income excluded for the discharge of qualified real property business debt reduces the basis of the taxpayer's depreciable real property [IRC Sec. 108(c)(1)]. [The reduction is made under IRC Sec. 1017, except the election to treat real property inventory as depreciable property is not available—IRC Sec. 1017(b)(3)(F).] The basis reduction is made first to the adjusted depreciable basis of the real property securing the discharged debt. Any excess reduces the depreciable bases of the taxpayer's other depreciable real property proportionately, based on each property's relative adjusted basis. The basis reduction is deemed to occur at the beginning of the tax year following the tax year during which the discharge occurs. However, if the property is disposed of before the beginning of the tax year following the discharge, the basis reduction occurs immediately before the disposition.

Example 2: Reducing the Basis of Depreciable Real Property

Ken Urent owns Garden Apartments. On July 1, 2008, the property has an adjusted basis of $2.2 million and outstanding nonrecourse debt of $2.5 million. The property's FMV is $2 million.

On July 1, 2008, the mortgage holder reduces the principal amount of the outstanding mortgage to $2 million, resulting in debt discharge income of $500,000. Ken elects to exclude this $500,000 of income under the qualified real property business debt rules. Therefore, his depreciable basis in the apartments is reduced by $500,000 as of January 1, 2009, and depreciation calculated for periods subsequent to that date will take the $500,000 basis reduction into account.

Preparation Pointer: If the basis of depreciable real property is reduced under the qualified real property rules, and the property is subsequently disposed of, the basis reduction is treated as a depreciation deduction in calculating ordinary income from depreciation recapture. The calculation of the amount of straight-line depreciation that would have been allowed is made as if no basis reduction had occurred [IRC Sec. 1017(d)(2)]. Thus, the amount of the basis reduction recaptured as ordinary income is reduced over time as the taxpayer forgoes depreciation deductions (because of the basis reduction).

Partnership Debt Reduced. For a discharge of partnership debt, the determination of whether debt is qualified real property business debt and the application of the FMV limitation is made at the partnership level (Ltr. Rul. 9426006). The election to apply the exclusion is made at the partner level on a partner-by-partner basis. When an election causes a basis reduction to the partner's allocable share of the partnership's depreciable real property, the partner's basis of his interest in the partnership and the partnership's basis of the depreciable realty allocated to the partner are reduced by such amount [IRC Sec. 1017(b)(3)(C) and (F)].

S Corporations Apply Rules at the Entity Level. The income exclusion under IRC Sec. 108, including the special rule on qualified real property debt, and any resulting reduction in tax attributes are applied at the S corporation level [IRC Sec. 108(d)(7)]. The Job Creation and Worker Assistance Act of 2002 amended IRC Sec. 108(d)(7)(A) to clarify that income excluded under IRC Sec. 108 does not increase a shareholder's basis in S corporation stock. The amendment is generally effective for debt discharges after October 11, 2001.

Warning: IRC Sec. 108(a)(1)(D) and (c) provides that gross income does not include any amount resulting from the discharge of qualified real property business indebtedness. Practitioners should note that this provision only applies to taxpayers **other than** C corporations.

Certain Student Loans—Special Rules

Cancellations of all or part of certain student loans obtained to attend qualified educational institutions do not result in gross income to the borrower. This special rule applies only to student loans that contain a provision stating that all or part of the loan will be canceled if the borrower works for a certain period of time in certain professions for any of a broad class of employers (i.e., a public service requirement), and the borrower satisfies such requirement. To qualify, the loan must be made by either [IRC Sec. 108(f)(2)]:

- a federal, state, or local government unit, or instrumentality, agency, or subdivision thereof;
- a tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law; or
- an educational institution that makes the loan under (a) an agreement with an entity described in item 1. or 2., or (b) a program of the institution to encourage students to serve in occupations or in areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or other tax-exempt organization.

Loans made by educational institutions and tax-exempt organizations to refinance loans that assist individuals in attending such educational institution also qualify, provided the refinancing is pursuant to a program as described in above. Loans from educational institutions and tax-exempt organizations do not qualify if the discharge is due to services the individual performs for the lender organization [IRC Sec. 108(f)(3)].

Observation: Congress enacted this special rule for certain student loans to encourage students to go into such occupations as medicine, nursing, and teaching in rural and low-income areas.

A Liability, the Payment of Which Leads to a Deduction

Taxpayers do not recognize income from a cancelled debt to the extent the payment would have lead to a deduction (IRC Sec. 108(e)(2)).

Example

Bill incurs $5,000 in deductible interest expense. The lender agrees to reduce the amount owed to $3,000. Even though there has been a $2,000 cancellation of indebtedness, Bill excludes the debt discharge income because the payment of the interest would have given rise to a deduction.

Example

Bill uses the cash method for his business. Bill incurs $10,000 in legal fees for his company. Bill is having trouble paying his bills, so his attorney agrees to reduce the amount owed to $6,000. Bill does not have to recognize the $4,000 in debt cancellation as income because the payment of the legal fees would have lead to a deduction.

Variation: Assume the debt forgiveness occurs two years after the liability was incurred. If Bill was using the accrual method for his business, the $4,000 in debt cancellation would have to be recognized as income. This is because under the accrual method legal fee expense is deductible in the year incurred.

Seller Financing

Debt discharge income is not recognized where:

- the debt arose from purchase of the property,
- the original seller of the property held the debt that was reduced, and
- the debtor was solvent at the time of the debt reduction

Example

TJ bought his rental property from Alex in 2004 for $500,000. Alex financed the purchase by taking back a mortgage from TJ for $450,000. TJ made timely payments until 2008 when he threatened to walk away from the debt since the property had greatly decreased in value.

Alex agreed to reduce the remaining balance from $445,000 to $375,000. TJ was solvent at the time.

TJ does not recognize debt discharge income but must reduce the basis in his property by $70,000 to reflect the reduction in the amount owed to Alex.

Special Rules for Principal Residence Debt

Certain discharges of home mortgage debt that occur in calendar years 2007-2009 are excludable from gross income. The 2007 Mortgage Relief Act allows taxpayers to exclude from gross income a discharge in whole or in part of qualified principal residence indebtedness.

Normally, debt forgiveness results in taxable income. But under the Mortgage Forgiveness Debt Relief Act of 2007, taxpayers may exclude debt forgiven on their principal residence if the balance of their loan was less than $2 million. The limit is $1 million for a married person filing a separate return.

Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, may qualify for this relief. In most cases, eligible homeowners only need to fill out a few lines on Form 982 (specifically, lines 1e, 2 and 10b).

The debt must have been used to buy, build or substantially improve the taxpayer's principal residence and must have been secured by that residence. Debt used to refinance qualifying debt is also eligible for the exclusion, but only up to the amount of the old mortgage principal, just before the refinancing. For these rules, the definition of a principal residence is the same as that under Section 121.

Debt forgiven on second homes, rental property, business property, credit cards or car loans does not qualify for the new tax-relief provision. In some cases, however, other kinds of tax relief—based on insolvency, for example—may be available. See Form 982 for details.

The exclusion does not apply to a taxpayer in a Title 11 bankruptcy. The regular Title 11 bankruptcy exclusion applies (IRC Sec. 108(a)(2)(A)). Insolvent taxpayers other than those in a Title 11 Bankruptcy can elect to not have this special exclusion apply and instead rely on the section 108 rules for insolvent taxpayers (IRC Sec. 108(a)(2)(C)).

The exclusion does also not apply where the discharge is on account of services performed for the lender or any factor not directly related to a decline in property value or the taxpayer's financial condition (IRC Sec. 108(h)(3)).

The basis of the taxpayer's principal residence must be reduced (but not below zero) by the amount of any income excluded under the 2007 Mortgage Relief Act (IRC Sec. 108(h)(1)).

Operative Rules

Most principal residential mortgages are recourse. As such, a foreclosure involving recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven. Therefore, it is possible a residential foreclosure transaction results in a gain or loss from the sale of property and debt discharge income. Only the portion of the transaction treated as debt discharge income is available for the special exclusion for Qualified Principal Residence Indebtedness. Any income from the foreclosure treated as a deemed sale is not available for the exclusion. But the income may be excluded under the Sale of Principal Residence Rules.

Example

Laurie, who is not bankrupt or insolvent, owns a principal residence with a FMV of $280,000 and basis of $270,000. The lender foreclosed in 2008 when the balance on the recourse loan was $300,000.

Results: Laurie has a gain of $10,000 ($280,000 – $270,000) and debt discharge income of $20,000. The debt discharge income is excludable under the Mortgage Relief Act of 2007. The $10,000 is reportable gain, unless Laurie can exclude gain under the sales of Principal Residence rules.

Variation: Assume the mortgage was nonrecourse debt.

Results: The foreclosure transfer is treated as a sale or exchange with the full amount of the debt treated as the amount realized, even if it is greater than the FMV at the time of transfer. Therefore, there is no debt discharge income and the exclusion rules do not apply.

Example

Assume the same facts as in the previous example except that the debt is all nonrecourse.

There is no debt discharge income and the exclusion rules provided by the 2007 Mortgage Relief Act do not apply. The residence is deemed to be sold for $300,000 and Laurie will be able to exclude the $30,000 in gain ($300,000 – $270,000) if she satisfies the rules that allow her to exclude gain from the sale of a Principal Residence.

Observation: For most taxpayers, there will probably be no net taxable income from the foreclosure of their principal residence. This is because the basis will equal or exceed the total amount of mortgage debt and the total debt forgiven will be less than $2,000,000/$1,000,000.

Other Tax Issues—Passive Activities

Debt discharge income resulting from debt allocated to passive activity expenditures (e.g., when a rental property's mortgage balance is reduced by a lender) is passive income and can be offset by passive losses (Rev. Rul. 92-92, 1992-2 CB 103). Debt discharge income resulting from the cancellation of investment-related debt is treated as investment income for purposes of the investment interest expense limitation (Ltr. Rul. 9522008).