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Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

TAX RELIEF AND HEALTH CARE ACT OF 2006

Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA) that extended tax breaks for millions of taxpayers. President George W. Bush signed the bill on December 20, 2006.

Much of the law simply extends existing legislation that expired on December 31, 2005. The law changed the expiration dates of many of these provisions to December 31, 2007. Other sections of the law made expired provisions a permanent part of the tax code and made technical changes to others. In addition, the law added new provisions to the Internal Revenue Code including enhancements of health savings accounts.

The table on the following page recaps the changes to existing provisions.

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Description	IRC Section	New Expiration Date
State and local sales tax deduction	164(b)(5)(I)	12/31/07
Higher education tuition deduction	222(e)	12/31/07
Teacher's classroom expense deduction	62(a)(2)(D)	12/31/07
Leasehold improvements deadline	168(e)(3)(E)(iv)	12/31/07
Qualified restaurant property deadline	168(e)(3)(E)(v)	12/31/07
New markets tax credit	48D(i)(6)	12/31/08
Earned income tax credit for combat pay	32(c)(2)(B)(vi)(II)	12/31/07
GO Zone bonus depreciation deadline	1400N(d)(6) and 1400N(e)(2)	12/31/10
Deduction for energy efficient commercial buildings	179D(h)	12/31/08
Credit for residential alternative energy expenditures	25D	12/31/08
Clean renewable energy bonds	54(f)(1), 45(f)(2), and 45(m)	12/31/08
Archer medical savings accounts	220(i)(2)	12/31/07
Indian employment tax credit	45A9F)	12/31/07
Accelerated depreciation for business property on a Native American reservation	168(j)(8)	12/31/07
D.C. Enterprise Zone and first-time homebuyers tax breaks	1400(f)(1) and 1400(f)(2)	12/31/07
Imputed interest on below market loans to qualified care facilities	7872(h)(4)	Made permanent
Authority to disclose taxpayer identity for employment reporting	6103(d)(5)(B)	12/31/07
Capital gain treatment on self-created musical works	1221(b)(3)	Made permanent
IRC §355 active trade or business test	355(b)(3)(A) and 355(b)(3)(D)	Made permanent

HEALTH SAVINGS ACCOUNTS

Note. See Chapter 1, "Individual Taxpayer Problems," Problem 2, "Health Savings Account Update," for the new rules regarding HSAs.

INCENTIVE STOCK OPTIONS[1]

When a corporation transfers a share of stock to any employee who exercises an incentive stock option (ISO), the corporation must furnish that person with a written statement containing information about the transfer. It must furnish a similar statement if it transfers stock acquired through the exercise of an option granted under an employee stock purchase plan (ESPP), provided the option is priced between 85% and 100% of the value of the stock.

The IRS can assess a penalty if these statements are not furnished on time or do not report the required information. Under old law, there was no requirement to furnish a similar statement to the IRS.

TRHCA requires the corporation to furnish a similar statement to the IRS for calendar years beginning after December 20, 2006.

MENTAL HEALTH PARITY REQUIREMENTS[2]

Group health plans may provide medical, surgical, and mental health benefits. Plans with all three benefits cannot impose limits on the aggregate lifetime or annual dollar limits to mental health benefits that differ from those on substantially all medical and surgical benefits. Failure to comply with the parity requirements can result in the IRS imposing an excise tax.

1. IRC §§6039(a), 6039(b) and 6724 (d)(1)(B)(xix)

2. IRC §9812(f)(3)

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Old Law. Under the prior law, the mental health parity requirements did not apply for services furnished:

1. On or after September 30, 2001, and before January 10, 2002;
2. On or after January 1, 2004, and before October 4, 2004; and
3. After December 31, 2006.

New Law. TRHCA applies an excise penalty for failure to comply with the parity rules through December 31, 2007. This rule is effective from the date of enactment of TRHCA.

RESEARCH CREDITS[3]

TRHCA changes the expiration date on the research credits from December 31, 2005 to December 31, 2007. The basic credit is 20% of the amount research exceeds a specific base amount. In addition to the basic credit, there are two alternative research credits.

Rates Increased for the Elective Alternative Incremental Research Credit[4]

Qualifying taxpayers have an option to claim an alternative incremental research credit rather than the basic research credit. TRHCA increases the rates for the alternative credit.

The alternative research credit applies only to amounts paid through December 31, 2007. Fiscal year taxpayers must use a formula to determine the amount of the credit.

Alternative Simplified Credit for Qualified Research Expenses[5]

This is a new credit established by TRHCA. This credit is 12% of the excess of the qualified research expenses for the tax year, over 50% of the average qualified research expenditures for the three tax years proceeding the tax year for which the credit is being determined.

The credit is 6% for those taxpayers who have no qualifying research expenses in the prior years.

3. IRC §§41(h)(1)(B) and 45C(b)(1)(D)
4. IRC §41(c)(4)(A)
5. IRC §§41(c)(4) and 41(c)(5)

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MORTGAGE INSURANCE PREMIUM DEDUCTION FOR 2007 ONLY[6]

TRHCA provides a **new** tax deduction for those individuals who purchase a home and buy qualified mortgage insurance. **The provision treats the mortgage insurance premium as qualified residence interest for 2007 only.** In addition, the deduction does not apply to any mortgage insurance contracts issued before January 1, 2007.

There is a phaseout on the deduction based on the taxpayer's AGI. For **all but** married filing separate taxpayers, the phaseout reduces the deduction by 10% for each $1,000 of AGI that exceeds $100,000 or a fraction thereof. For married filing separate taxpayers, the phaseout amount is $500 for each $1,000 of AGI that exceeds $50,000 or fraction thereof.

Example 1. John and Mary file a 2007 joint tax return. Their AGI is $105,500 and they paid $2,500 of qualified home mortgage insurance. They must reduce their allowable deemed interest deduction by 60% or $1,500. They are entitled to deduct $1,000 ($2,500 less the $1,500 reduction) on their 2007 Schedule A as qualified residence interest.

Prepaid mortgage insurance premiums are deductible only in the year allocable. Because this deemed home mortgage interest deduction is in effect only for 2007, no deduction is permitted for most prepaid premiums. However, if the Veterans Administration (VA) or Rural Housing Administration (RHA) provides the mortgage insurance, and the premium is for the entire life of the loan, the entire premium is deductible if paid in 2007.

Note. The mortgage insurance premium is reported on Form 1098, *Mortgage Interest Statement*, in box 4.

☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, address, and telephone number	* **Caution:** *The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.*	OMB No. 1545-0901 2007 Form **1098**	**Mortgage Interest Statement**
RECIPIENT'S federal identification no. / PAYER'S social security number	1 Mortgage interest received from payer(s)/borrower(s)* $		**Copy B For Payer**
PAYER'S/BORROWER'S name	2 Points paid on purchase of principal residence $		The information in boxes 1, 2, 3, and 4 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points or because you did not report this refund of interest on your return.
Street address (including apt. no.)	3 Refund of overpaid interest $		
City, state, and ZIP code	4 Mortgage insurance premiums $		
Account number (see instructions)	5		

Form **1098** (keep for your records) Department of the Treasury - Internal Revenue Service

6. IRC §§163 and 6050H

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ALTERNATIVE MINIMUM TAX

Note. See pages 59–63 in the 2006 *University of Illinois Federal Tax Workbook* for a thorough analysis of the minimum tax credit rules that existed prior to enactment of TRHCA. **See Chapter 1, "Individual Taxpayer Problems," Problem 1, "Alternative Minimum Tax Update," for the new rules regarding AMT.**

TAXPAYER PENALTY FOR FILING FRIVOLOUS TAX RETURNS[7]

In a further attempt to curb the filing of frivolous tax returns, TRHCA increases the taxpayer penalty from $500 to $5,000. A frivolous tax return is a return that does not contain substantially correct information to calculate the tax liability.

TRHCA broadens the types of returns to which the penalty applies from income tax returns, to all types of federal taxes. The increased penalty also applies to frivolous submissions for lien and levy collection due process, installment agreements, offers-in-compromise, and taxpayer assistance orders.

The new law is effective for frivolous tax return submissions made and issues raised after March 15, 2007. See Notice 2007-30 in Chapter 15, "Rulings and Cases," for the IRS list of frivolous submissions.

INCENTIVE FOR MINE SAFETY TRAINING AND EQUIPMENT[8]

A 20% general business credit is available for training expenses of mine rescue teams. The law provides definitions of qualified mine rescue teams, eligible employees, and wages. This law is effective for amounts paid or incurred after December 31, 2005 and before January 1, 2009.

ENHANCED HOME-SALE EXCLUSION RULES FOR MEMBERS OF THE INTELLIGENCE COMMUNITY[9]

To qualify for the $250,000/$500,000 income exclusion on the gain from the sale of a personal residence, the taxpayer must own the residence and use it as his personal residence for two of the prior five years ending on the date of exchange or sale. If health, employment, or unforeseen circumstances trigger the sale or exchange, the taxpayer may be entitled to a reduced exclusion amount.

Taxpayers who are away from the residence because of service in the uniformed services, or U.S. Foreign Service may suspend the 5-year period for up to 10 years. **TRHCA extends this exclusion to employees of the intelligence community.**

Members of the intelligence community include the following:

- Office of the Director of National Intelligence
- Central Intelligence Agency
- National Security Agency
- Defense Intelligence Agency
- National Geospatial-Intelligence Agency
- National Reconnaissance Office
- Any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs

7. IRC §6702
8. IRC §§45N, 38(b)(31), and 280(c)(e)
9. IRC §121

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- Any of the intelligence elements of the Army, Navy, Air Force, Marine Corps, Federal Bureau of Investigation, Department of Treasury, and Coast Guard
- Bureau of Intelligence and Research of the Department of State
- Any of the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information

To qualify for the extension, the member of the intelligence community must be on official extended duty at a **duty station outside of the U.S.** The sale or exchange must occur before January 1, 2011, for the suspension period to apply.

> **Example 2.** Dana, a single taxpayer, works for the National Security Agency (NSA). She lives in Chicago, Illinois, and purchased a condominium there on January 5, 2001. She moved into the condominium immediately after the closing. On January 10, 2002, the NSA transferred her to a duty station in Colombia (South America) where she remains until January 2010. She returns to the U.S. and sells the condominium in February 2010.
>
> Dana lived in the condominium for only 12 months. She may elect the 10-year suspension and qualify for a reduced IRC §121 exclusion of $125,000 ((12 ÷ 24) × $250,000).

This provision is effective for sales or exchanges after December 20, 2006 and before January 1, 2011.

EXPANSION OF IRC §199 DEDUCTION

For the first two tax years beginning after 2005, TRHCA retroactively allows the domestic production activity deduction for production activities in Puerto Rico. Any wages paid to bona fide residents of Puerto Rico are included when calculating the 50% of W-2 wages limitation.

These new rules are effective for the first two tax years of a taxpayer beginning after December 31, 2005 and before January 1, 2008.

PERCENTAGE DEPLETION TAXABLE INCOME LIMIT SUSPENDED[10]

In certain cases, taxpayers may recover their gas and oil well investments using percentage depletion. However, they are restricted in the amount they may deduct. The deduction is limited to 100% of the taxable income from the property in any year. Gas and oil produced from marginal wells are subject to special percentage depletion rules.

TRHCA suspends the "100% of taxable income" limitation on percentage depletion from marginal gas and oil wells for years beginning before January 1, 2008. As a result, independent producers will realize the full benefit of percentage depletion.

The suspension is effective for tax years beginning after December 31, 2005 and before January 1, 2008.

BONUS DEPRECIATION FOR QUALIFIED CELLULOSIC BIOMASS ETHANOL PROPERTY[11]

TRHCA entitles qualified cellulosic biomass ethanol property (QCBEP) to a 50% depreciation allowance in the year it is placed into service. The bonus depreciation is allowable only by meeting specific requirements.

No AMT adjustment is required if the property qualifies for the bonus depreciation. To qualify, the property must be in service before January 1, 2013. This provision applies to cellulosic ethanol, which is derived from switch grass, wood fibers, shell hulls, agricultural residue, and other organic sources.

---

10. IRC §613A(c)(6)(H)
11. IRC §168(l)

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WHISTLEBLOWER REWARDS INCREASED[12]

Old Law. The IRS paid informers up to 15% of the amount collected due to information provided regarding underpayments and the violation of tax laws. The rewards ranged from $100 to $10 million.

New Law. TRHCA authorizes the IRS to pay increased rewards for information regarding violations of tax law. The reward range for such information is 15% to 30% of the amount collected by the IRS, including penalties and interest where the amount disputed exceeds $2 million.

The new law is effective for information provided on or after December 20, 2006.

> **Note.** Information on the Whistleblower Office can be found in Chapter 2, "Ethics."

SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007

On May 25, 2007, the president signed the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007. A number of tax law changes were also included in this act. These changes are in the Small Business and Work Opportunity Act of 2007 (SBWOA) subpart of the act.

PREPARER DEFINITIONS AND PREPARER PENALTIES IN SBWOA

> **Note.** Preparer penalty provisions of SBWOA are discussed in Chapter 2, "Ethics," under "Tax Malpractice" and in Chapter 15, "Rulings and Cases" under "IRS Procedures — Penalties."

INCREASED EXPENSING FOR SMALL BUSINESS

SWBOA increases the IRC §179 deduction limits for **tax years beginning after December 31, 2006.** The maximum dollar amount of the deduction is **$125,000** for 2007. The deduction is limited if the amount of qualified property placed in service during the tax year exceeds **$500,000**. These amounts are indexed for inflation after 2007.

Example 3. Yestraw, Inc., purchased a used CAT excavator for $575,000 on February 24, 2007. The company's fiscal year end is December 31. This is the only piece of equipment the company purchased in 2007. Before taking any depreciation, the company's net profit is $200,000. The maximum amount that it may elect to deduct under IRC §179 is $50,000.

Cost of total assets placed in service	$575,000
Less the threshold	(500,000)
Amount over the threshold	$ 75,000
Maximum amount of §179 deduction	$125,000
Less the amount over the threshold	(75,000)
Dollar limitation for the §179 deduction	$ 50,000

Since Yestraw is a construction contractor, Yestraw depreciates the remaining cost of the excavator under MACRS with a 5-year recovery period.

Total cost of the excavator	$575,000
Less the elected §179 deduction	(50,000)
Remaining amount to be depreciated	$525,000

Yestraw's Form 4562, *Depreciation and Amortization*, is shown on the following page.

12. IRC §§7623 and 7443a

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For Example 3

Form **4562** — Department of the Treasury, Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172 — **2007** — Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Yestraw Inc	Construction	22-2222222

Draft as of 06/20/2007

Part I Election To Expense Certain Property Under Section 179

Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$125,000
2	Total cost of section 179 property placed in service (see instructions)	2	575,000
3	Threshold cost of section 179 property before reduction in limitation	3	$500,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	75,000
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	50,000

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6	Excavator	575,000	50,000

7	Listed property. Enter the amount from line 29	7		
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7		8	50,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8		9	50,000
10	Carryover of disallowed deduction from line 13 of your 2006 Form 4562		10	0
11	Business income limitation. $200,000 before depreciation less $105,000 from line 19b(g) below.		11	95,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11		12	50,000
13	Carryover of disallowed deduction to 2008. Add lines 9 and 10, less line 12 ▶	13		

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)

14	Special allowance for qualified New York Liberty or Gulf Opportunity Zone property (other than listed property) and cellulosic biomass ethanol plant property placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.) (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2007	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2007 Tax Year Using the General Depreciation System

	(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a	3-year property						
b	5-year property		525,000	5.0 yrs	HY	200DB	105,000
c	7-year property						
d	10-year property						
e	15-year property						
f	20-year property						
g	25-year property			25 yrs.		S/L	
h	Residential rental property			27.5 yrs.	MM	S/L	
				27.5 yrs.	MM	S/L	
i	Nonresidential real property			39 yrs.	MM	S/L	
					MM	S/L	

Section C—Assets Placed in Service During 2007 Tax Year Using the Alternative Depreciation System

20a	Class life					S/L	
b	12-year			12 yrs.		S/L	
c	40-year			40 yrs.	MM	S/L	

Part IV Summary (see instructions)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	155,000
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2007)

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EXPANSION AND MODIFICATION OF THE TIP CREDIT

Background. Employers are allowed to pay tipped employees less than minimum wage if the combination of tips and hourly wages equals or exceeds the minimum wage. The actual minimum hourly wage varies by state. When computing employer taxes, employer-provided wages include employee tip income.

Food service employers may claim a business tax credit based on tips reported. Unused credits are carried back one year and forward 20 years. There is no election to forego the carry-back period.[13]

Old Law. The credit was equal to the employers FICA taxes paid on tips in **excess** of those treated as wages for purposes of meeting the **federal minimum wage** requirements. This credit could **not** offset alternative minimum taxes (AMT).

New Law. Effective for tips received for services performed after December 31, 2006, the tip credit is determined based on a minimum wage of **$5.15 per hour, regardless of the actual minimum wage.** In addition, this credit is **allowed to offset AMT** for tax years beginning after December 31, 2006.

> **Note.** Employers use $5.15 per hour even if they must pay employees a higher minimum wage under state or federal law.

Example 4. Tomorrows is a small restaurant in Dyersburg, Tennessee. Tomorrows has one tipped employee, Justin. In 2007, Justin works 2,000 hours. The company pays him $3 per hour, and he reports a total of $8,000 in tips. He does not work overtime.

His total income from working at Tomorrows is:

Wages ($3 × 2,000 hours)	$ 6,000
Tips	8,000
Total wages and tips	$14,000

For purposes of calculating the tip credit, the amount of compensation that is not eligible for the credit provisions is $5.15 per hour × 2,000 hours, or $10,300.

Excluded compensation	$10,300	
Wages received	(6,000)	
Excluded tips	$ 4,300	
Total tips received	$ 8,000	(Line 1)
Less excluded tips	(4,300)	(Line 2)
Tips eligible for the credit	$ 3,700	(Line 3)

Tomorrows does not have any regular income tax for 2007; however, it is liable for $500 in AMT before applicable credits. Tomorrows' Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*, is shown below. Part II of the form is new for 2007.

Tomorrows should reduce its deduction for employment taxes by the tip credit of $283.

> **Caution.** The calculation shown in the example above is for illustration purposes only. The instructions for Form 8846 require this calculation on a monthly basis.

13. IRC §39(a)

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For Example 4

Form **8846** — Department of the Treasury, Internal Revenue Service

Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips

► Attach to your tax return.

OMB No. 1545-1414

2007

Attachment Sequence No. **98**

Name(s) shown on return: **Tomorrows**

Identifying number: **20-1234567**

Note. *Claim this credit **only** for social security and Medicare taxes paid by a food or beverage establishment where tipping is customary for providing food or beverages. See the instructions for line 1.*

Draft as of 07/26/2007

Part I Current Year Credit

1	Tips received by employees for services on which you paid or incurred employer social security and Medicare taxes during the tax year (see instructions)	1	8,000
2	Tips not subject to the credit provisions (see instructions)	2	4,300
3	Creditable tips. Subtract line 2 from line 1	3	3,700
4	Multiply line 3 by 7.65% (.0765). If you had any tipped employees whose wages (including tips) exceeded $97,500, see instructions and check here ► ☐	4	283
5	Credit for employer social security and Medicare taxes paid on certain employee tips from partnerships and S corporations	5	
6	Add lines 4 and 5. Partnerships and S corporations, report this amount on Schedule K; all others, go to line 7	6	283
7	Credit for employer social security and Medicare taxes paid on certain employee tips included on line 6 from passive activities (see instructions)	7	
8	Subtract line 7 from line 6	8	283
9	Credit for employer social security and Medicare taxes paid on certain employee tips allowed for 2007 from passive activities (see instructions)	9	
10	Carryback of the credit for employer social security and Medicare taxes paid on certain employee tips from 2008 (see instructions)	10	
11	Add lines 8 through 10. Use this amount to complete Part II	11	283

Part II Allowable Credit

12	Regular tax before credits (see instructions)			12	0
13	Alternative minimum tax (see instructions)			13	500
14	Add lines 12 and 13			14	500
15a	Credits from Form 1040, lines 47 through 50 and 52 through 54 (or Form 1040NR, lines 44, 45, and 47 through 49)	15a			
b	Foreign tax credit	15b			
c	Credits from Forms 5735 and 8834	15c			
d	Non-business alternative motor vehicle credit (Form 8910, line 18)	15d			
e	Non-business alternative fuel vehicle refueling property credit (Form 8911, line 19)	15e			
f	Add lines 15a through 15e			15f	0
16	Net income tax. Subtract line 15f from line 14. If zero, skip lines 17 through 20 and enter -0- on line 21			16	500
17	Net regular tax. Subtract line 15f from line 12. If zero or less, enter -0-			17	0
18	Enter 25% (.25) of the excess, if any, of line 17 over $25,000 (see instructions)			18	0
19	Subtract line 18 from line 16. If zero or less, enter -0-			19	500
20a	General business credit (Form 3800, line 19)	20a			
b	Empowerment zone and renewal community employment credit (Form 8844, line 26)	20b			
c	Work opportunity credit (Form 5884, line 22)	20c			
d	Alcohol fuels credit (Form 6478, line 24)	20d			
e	Renewable electricity, refined coal, and Indian coal production credit (Form 8835, line 43)	20e			
f	Add lines 20a through 20e			20f	0
21	Subtract line 20f from line 19. If zero or less, enter -0-			21	500
22	**Credit allowed for the current year.** Enter the smaller of line 11 or 21. Report this amount on Form 1040, line 55; Form 1040NR, line 50; Form 1120, Schedule J, line 5c; or the applicable line of your return. If line 21 is smaller than line 11, see instructions			22	283

For Paperwork Reduction Act Notice, see back of form. Cat. No. 16148Z Form **8846** (2007)

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FAMILY BUSINESS TAX SIMPLIFICATION

Under the new law, a qualified joint venture conducted by a husband and wife who file a joint return **may elect not to be treated as a partnership** for federal tax purposes.

A qualified joint venture is a trade or business in which:

- The only members of the joint venture are husband and wife,
- Both spouses materially participate in the venture, and
- Both spouses elect to have the provisions apply.

Both spouses will file the appropriate forms (i.e., Schedules C, F, etc.) which represent their respective investments in the venture. Each spouse's share of income or loss is included in his or her net earnings from self-employment.

Observations.

1. For LLCs taxed as partnerships, consideration should be given to the legal implications of electing this treatment. If a husband and wife partnership opt to report their business operations on two Schedule Cs (or Fs), this may jeopardize their "corporate veil" protection. Therefore, an attorney familiar with the particular state's LLC statutes should be consulted.
2. Couples who hold rental properties or raw land in partnerships or LLCs are not affected by this law change. They continue to file Form 1065. This election only applies to couples conducting businesses.
3. Couples may realize higher tax savings if one person owns 100% of the business and the other is an employee. This may allow the sole proprietor to provide tax-free fringe benefits to the employee-spouse, such as medical reimbursement plans.
4. Couples should also consider state tax laws before making this election. Some states require filing a partnership return, even if it is not required for federal tax purposes. In addition, some states have tax benefits that apply when the business files an entity return that do not apply if the business activity is reported on Form 1040.
5. Taxpayers may want to consult with their attorney to ensure that this treatment does not imperil their estate plans.

WORK OPPORTUNITY TAX CREDIT

The work opportunity tax credit (WOTC) is a business credit available to employers who hire individuals from one or more of nine targeted groups. The amount of wages paid to qualifying individuals determines the credit amount. A designated local agency must certify individuals as members of targeted groups.

Within each group, specific requirements apply in determining if an individual is a qualifying member. However, in general, the nine groups are the following:

- Families receiving benefits under the Temporary Assistance for the Needy Families Program
- Qualified veterans
- Qualified ex-felons
- High-risk youth
- Recipients of vocational rehabilitation
- Summer youth employees living in certain communities
- Food stamp recipients
- SSI recipients
- Long-term family assistance recipients

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SBWOA changes the application of the WOTC by:

1. Allowing the WOTC to offset AMT for tax years beginning after December 31, 2006,
2. Extending the credit through August 31, 2011,
3. Expanding the definition of qualified veterans and increasing the amount of wages that qualify for the credit when paid to certain veterans,
4. Expanding the definition of high-risk youths, and
5. Expanding the definition of members of the vocational rehabilitation referral targeted group.

For individuals qualifying under the expanded definitions, the credit is only available if the employee begins work for the taxpayer after May 25, 2007.

> **Note.** See Issue 8 in Chapter 12, "Agricultural Issues and Rural Investments," for further discussion of the WOTC as it applies to workers in rural renewal counties.

S CORPORATION PROVISIONS

SWBOA made six changes to the IRC provisions affecting S corporations.

1. Capital Gains not Treated as Passive Investment Income

An S corporation is subject to corporate-level tax **at the highest corporate tax rate** (currently 35%) on its excess net passive income if:

- The corporation has C corporation accumulated earnings and profits at the close of the taxable year, and
- More than 25% of its gross receipts are from passive investment income.

This only applies if the corporation was a C corporation before it elected to be an S corporation. **SWBOA eliminates gains from sales or exchanges of stock or securities as items of passive investment income.** This change is effective for tax years beginning after May 25, 2007. For calendar-year corporations, this change is effective beginning January 1, 2008.

> **Observation.** S corporations with **accumulated earnings and profits** from C Corporation years, should consider declaring a dividend of the earnings and profits. This would eliminate the corporate level tax on excessive net passive income.
>
> These dividends are taxable to the shareholders on their personal form 1040 Schedule B as corporate dividend income. Under current law, these dividends are taxed at favorable capital gain rates, plus state income tax.
>
> See Chapter 10, "S Corporations," for more information about Distribution Elections and the **deemed dividend election** for cash poor corporations.

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2. Restricted Bank Director Stock

National banking law requires that a national bank director own stock in the bank and that a bank have at least five directors. A number of states have similar requirements for state-chartered banks. Restricted bank director stock owned for these purposes does not count against the corporation when determining if the S corporation has more than one class of stock, or has too many shareholders, and so on. This change is effective for tax years beginning after December 31, 2006.

3. Expanded IRC §481 Options for Banks

A financial institution, which uses the reserve method of accounting for bad debts, may not elect to be an S corporation. If it changes from the reserve method, IRC §481 requires certain adjustments to prevent the duplication or omission of amounts from future returns. Generally, additions to taxable income are spread over four taxable years, beginning in the year of change. Reductions to taxable income are generally taken into account entirely in the year of change. SWBOA allows a bank to elect to account for these adjustments in the last taxable year it was a C corporation, if it changes from the reserve method for its first taxable year as an S corporation. This change is effective for tax years beginning after December 31, 2006.

4. Expansion of IRC §351 Provisions

An S corporation that owns all the stock of another company may elect to treat the subsidiary corporation as a qualified subchapter S subsidiary (QSub). A QSub is disregarded as a separate entity for federal tax purposes.

If the subsidiary ceases to be a QSub, the subsidiary is treated as a new corporation acquiring its assets from the parent S corporation in exchange for its stock. **Under old law**, this could mean that the parent corporation must treat the entire transfer as a deemed sale. If after the sale the QSub does not meet the requirements of IRC §351, the entire gain would be reportable.

Under new law, if the sale of QSub stock results in the termination of the QSub election, the sale is treated as a sale of an undivided interest in the assets of the QSub followed by a deemed transfer to the Qsub of the remaining assets and liabilities. The deemed transfer qualifies as an IRC §351 reorganization, and only the realized gain or loss from the sale is recognized. This change is effective for tax years beginning after December 31, 2006.

5. Earnings and Profits Attributable to Pre-1983 Years

This provision applies to corporations that were S corporations prior to 1983 but were **not** S corporations for their first taxable year after December 31, 1996. The portion of accumulated earnings and profits (AEP) that was accumulated in pre-1983 S corporation years is subtracted from the total AEP of these corporations. This change is effective for tax years beginning after May 25, 2007. For calendar-year corporations, this change is effective beginning January 1, 2008.

6. Deductibility of Interest Expense of an ESBT

This provision only applies to electing small business trusts (ESBT). It allows the ESBT to deduct interest expense incurred on debt used to acquire S corporation stock when computing the taxable income from the S corporation. This change is effective for tax years beginning after December 31, 2006.

GULF OPPORTUNITY ZONE TAX INCENTIVES

The following provisions of SWBOA that relate to the Gulf Opportunity Zone (GO Zone) are effective in 2007:

1. Low-income housing credit rules have been extended and expanded for buildings in the GO Zone. These provisions are effective as of May 25, 2007.
2. Tax-exempt bond treatment applies to financing used for repairs and reconstructions of qualified residences in the GO Zone. This provision applies to owner financing provided after May 25, 2007, and before January 1, 2011.

Taxpayers concerned with GO Zone issues should consult IRS Pub. 4492, *Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.*

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REVENUE RAISERS EFFECTIVE IN 2007

IRS Notification Period Changes

Old Law. In general, interest and penalties accrue during periods for which taxes are unpaid without regard to whether the taxpayer is aware that there is tax due. The IRC suspends the accrual of certain penalties and interest starting **18 months** after the filing of the tax return if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. If the return is filed before the due date, for this purpose it is considered to have been filed on the due date.

Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax.

The suspension applies only to taxpayers who are individuals and who file a timely tax return. In addition, the provision does not apply to the failure-to-pay penalty, in the case of fraud, or to criminal penalties. Generally, the provision also does not apply to interest accruing on underpayments resulting from listed transactions or undisclosed reportable transactions.

New Law. The IRS has **36 months** after the filing of the tax return before penalties and interest are suspended.

IRS Levies

If a taxpayer requested a collection due process (CDP) hearing that related to unpaid employment taxes in the 2-year period before the beginning of a period that relates to a **new** employment tax levy, the new levy is excepted from the **pre-levy** CDP hearing requirement. However, the taxpayer may still request a CDP hearing within a reasonable period after the levy. This provision is effective for levies issued on or after September 22, 2007.

Checks and Money Orders

The minimum penalty for bad checks or money orders increased from $15 to $25 for drafts less than $1,250. If the amount of the check or money order is less than $25, the penalty is limited to the amount of the draft. For amounts over $1,250, the penalty is 2%. This provision is effective for checks or money orders received after May 25, 2007.

Erroneous Claims

Taxpayers filing an erroneous claim for refund or credit are subject to a penalty equal to 20% of the disallowed portion of the claim when there is no reasonable basis for the claim. This penalty does not apply to claims relating to the earned income credit or claims already subject to accuracy-related or fraud penalties. This provision is effective for erroneous claims filed after May 25, 2007.

TAX CHANGES TAKING EFFECT AFTER DECEMBER 31, 2007

Kiddie Tax

Under the old law, unearned income of certain children under age 14 was subject to tax at their parents' marginal rate. In 2006, the age increased to children **under age 18**. Starting in 2008, the provision expands the kiddie tax to apply to children who are:

- 18 years old, **or**
- Full time students over age 18 but under age 24.

The **expanded provision** applies only to children whose **earned income does not exceed one-half of their support.** Children under age 18 who are self-supporting are still subject to the kiddie tax **regardless of the source** of their income.

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Earned income includes wages and other compensation for personal services. Almost everything else included in AGI is unearned income.

Example 5. Keith is a full-time student at the University of Illinois during both 2007 and 2008. By the end of 2007, he will be 22, and by the end of 2008, he will be 23. His parents are alive, and he is not married.

Keith supports himself with rent income he receives from property he inherited from his grandfather. Since he provides over one-half of his own support, his parents cannot claim him.

He prepares his 2007 tax return with no thought about his parents' return. However, for 2008, the kiddie tax provisions apply to him, and he will need information from his parents' return in order to complete his return.

Observations.

1. Even though Keith provides over one-half of his own support, he does so with **unearned** income. If he supported himself with **earned** income, the exception would apply to him.
2. If Keith supported himself with investment earnings, the result in **Example 5** would be the same.
3. The new tax law will hinder the post-2007 family tax planning strategy of parents who intended to transfer assets to children. This strategy anticipated that the donee children would sell the gifted appreciated assets and take advantage of the zero tax rate on net capital gains for tax years 2008 through 2010. For more information on this topic see the notebox at the end of Issue 2, "Planning for the Zero Tax Rate on Net Capital Gains and Qualified Dividends," in Chapter 3, "Investment Issues."
4. Practitioners may want to suggest to clients whose children own appreciated assets like stock to sell these investments in 2007 instead of waiting until 2008. In addition, parents should consider gifting their appreciated stock to their age 18 or over children before the end of 2007. If the children sell the gifted stock before December 31, 2007, any gain is likely to be taxed at a 5% rate.

The kiddie tax rules apply **whether or not either parent can claim the child as a dependent.** They also apply even though a child's exemption is phased out on the parent(s)' return. However, they do not apply to children whose **parents are both deceased** as of the end of the tax year or to **children who file joint returns** for the tax year.

IRC §179 Provisions Extended

Note the following regarding IRC §179 provisions:

1. The right to revoke or change the IRC §179 election extends to tax years beginning before January 1, 2011.
2. The inclusion of off-the-shelf computer software as IRC §179 property extends to tax years beginning before January 1, 2011.
3. Previous legislation established higher deductions for IRC §179 property placed in service in the GO Zone. The new law extends the deadline for placing the property into service from December 31, 2007 until December 31, 2008.

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