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## Individual Taxation Report

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# Individual Taxation Report

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**T**his article covers recent developments affecting taxation of individuals, including legislation, regulations, and IRS guidance. The items are arranged in Code section order.

### Sec. 1: Tax Imposed

Thanks to changes made by the Jobs Growth and Tax Relief Reconciliation Act of 2003,<sup>1</sup> taxpayers in the 15% or lower tax brackets have a 0% capital gains rate for tax years beginning after 2007 and before 2011.<sup>2</sup>

### Sec. 55: Alternative Minimum Tax Imposed

The Tax Court held<sup>3</sup> that the Sec. 6654 estimated tax penalty is not part of a taxpayer's regular income tax liability and thus does not reduce the taxpayer's alternative minimum tax (AMT). The Service increased the taxpayers' regular tax liability for the tax year at issue (due to a math error) and also assessed a penalty for failure to pay estimated tax. The taxpayers argued that the estimated tax penalty should be included in their regular tax liability when calculating their AMT. The court held that because "regular tax liability" means taxes imposed under chapter 1 of the Code<sup>4</sup> and the Sec. 6654 estimated tax penalty is imposed under chapter 68 of the Code, the Service correctly omitted the amount of the penalty

when calculating the taxpayers' AMT liability.

### Sec. 62: Adjusted Gross Income Defined

The Office of Chief Counsel advised<sup>5</sup> that a plan that merely treats payments to employees that had previously been treated entirely as wages as being partially payments of wages and partially reimbursements of expenses was not an accountable plan because it violated the business connection requirement for accountable plans in Regs. Sec. 1.62-2(c). In the case at issue, an employer, who required employees to provide their own tools for use in their jobs, set up a plan that characterized part of the participating employees' wages as nontaxable reimbursements for the amounts the employees spent on tools used in their jobs.

### Sec. 104: Compensation for Injuries or Sickness

A taxpayer received damages through a settlement for an action brought for discrimination in the workplace. The Tax Court held that because there was no

1 Jobs Growth and Tax Relief Reconciliation Act of 2003, P.L. 108-27.

2 Sec. 1(h)(1)(B).

3 *Alston*, T.C. Summ. 2007-155.

4 Sec. 26(b).

5 CCA 200745018 (11/9/07).

payment for tort-like personal injuries, the amount received was not excludible from income under Sec. 104.<sup>6</sup> The court stressed that the nature of the claim as detailed in the settlement agreement is relevant in determining if Sec. 104 applies. If the settlement agreement does not expressly state the purpose of the payment, then the intent of the payor is relevant to determine the purpose. The court held that "although the belief of the payee is relevant to that inquiry, the character of the settlement payment hinges ultimately on the dominant reason of the payor in making the payment."

In April 2008, the Supreme Court declined to hear the *Murphy*<sup>7</sup> case, in which a taxpayer sought to recover income taxes she paid on compensatory damages for emotional distress and loss of reputation she was awarded in an administrative action against her former employer. This case is notable because the DC Court of Appeals originally held (in an opinion that it ultimately vacated) that taxing compensatory damages was a violation of the 16th Amendment because compensatory damages were not income.

### Sec. 152: Dependent Defined

**Qualifying relative:** Notice 2008-5,<sup>8</sup> issued on December 18, 2007, provides guidance under Sec. 152(d) for determining whether an individual is a qualifying relative for whom the taxpayer may claim a dependency exemption under Sec. 151(c). As such, the notice affects some family-based benefits for which a taxpayer may be eligible based on the presence of a qualifying relative, including, for example, in the case of a physically or mentally disabled individual, the Sec. 21 child and dependent care credit.

Sec. 152(d)(1)(D) provides that an individual is not a qualifying relative of the taxpayer if the individual is a qualifying child of any other taxpayer. Since the adoption of the "uniform definition of a child" and amendments to Sec. 152 defining "qualifying child" and "qualifying relative" as part of the Working

Families Tax Relief Act of 2004,<sup>9</sup> commentators have noted some of the unintended consequences of the new law. For example, in a February 6, 2006, letter to the Service, the National Association of Enrolled Agents presented several problem scenarios, including the following:

**Example 1:** A 30-year-old man, A, who lives with and completely supports his 28-year-old girlfriend, B, and her 5-year-old son, C, could claim the girlfriend as a dependent under the qualifying relative rules (assuming the relationship does not violate law). However, A would not be able to claim C because C is B's qualifying child, and an individual who is a qualifying child of one taxpayer may not be the qualifying relative of another taxpayer.

Notice 2008-5 clarifies that an individual is not a qualifying child of "any other taxpayer" if the individual's parent (or other person with respect to whom the individual is defined as a qualifying child) is not required by Sec. 6012 to file an income tax return and (1) does not file an income tax return or (2) files an income tax return solely to obtain a refund of withheld income taxes.

Referring back to Example 1 and assuming that all other requirements under Secs. 151 and 152 are met and that B is not required by Sec. 6012 to file a tax return, Notice 2008-5 provides that C is not treated as a qualifying child of B, and A may claim both B and C as his qualifying relatives. Any family-based benefits that accrue based on the appropriate dependency exemption would also be available to A.

The notice includes further examples:

**Example 2:** Assume the same facts as in Example 1, except that B has earned income of \$1,500 during tax year 2006, had income withheld from her wages, and is not required by Sec. 6012 to file an income tax return. With

## EXECUTIVE SUMMARY

- Taxpayers in the 15% or lower tax brackets have a 0% capital gains rate for tax years beginning after 2007.
- The IRS provided guidance on when a person is a qualifying relative for purposes of the dependency exemption.
- A 2% shareholder-employee in an S corporation may now be able to claim the deduction for self-employed health insurance premiums.
- The IRS provided guidance on what constitutes qualified performance-based compensation for purposes of the Sec. 162(m) limit on the deduction of compensation.
- The IRS withdrew regulations on when accounts or notes receivables are acquired for services rendered within the meaning of Sec. 1221(a)(4).

one qualifying child, B could claim an EITC of \$519.

If B does not claim the EITC but files a tax return only to obtain a refund of withheld income taxes, then C is not considered a qualifying child of B or any other taxpayer, and A may claim both B and C as his qualifying relatives. On the other hand, if B files a tax return to obtain the EITC and not solely to obtain a

<sup>6</sup> *Phelps*, T.C. Memo. 2008-86.

<sup>7</sup> *Murphy*, 493 F.3d 170 (D.C. Cir. 2007), cert. denied Sup. Ct. Dkt. 07-802 (U.S. 4/21/08). For more on this case, see Cook et al., "Recent Developments in

Individual Taxation," 39 *The Tax Adviser* 82 (February 2008).

<sup>8</sup> Notice 2008-5, 2008-2 I.R.B. 256.

<sup>9</sup> Working Families Tax Relief Act of 2004, P.L. 108-311.

# Individuals

refund of withheld income taxes, then C is a qualifying child of another taxpayer (B), and A may not claim C as a qualifying relative.

**Note:** The notice applies to all tax years beginning after December 31, 2004.

**CCA 200812024:** In February 2008, the IRS Chief Counsel<sup>10</sup> made the following distinctions with regard to the application of Notice 2008-5, noting that whether a taxpayer may claim specified family-based benefits depends on the relationship of the taxpayer to the individual:

- A taxpayer who may claim an individual as his or her *qualifying relative* under Notice 2008-5 may not use that individual for purposes of claiming the earned income credit because the credit requires that the dependent be a *qualifying child*, not a qualifying relative, of the taxpayer.
- A taxpayer who may claim an individual as his or her *qualifying relative* under Notice 2008-5 because that individual was a member of the taxpayer's household, but who does not have a specified familial relationship to the individual, may not claim head of household filing status.
- A taxpayer who may claim an individual as his or her *qualifying relative* under Notice 2008-5 may not use that individual for purposes of claiming the child tax credit because the credit requires that the dependent be a *qualifying child*, not a qualifying relative, of the taxpayer.
- Section 152(a)(1) provides that a dependent is a *qualifying child*; therefore, the dependent care credit is limited to taxpayers with one or more *qualifying children* under the age of 13. A taxpayer who may claim an individual as his or her *qualifying relative* may not claim the dependent care credit unless that qualifying relative is physically or mentally disabled

## Sec. 162: Trade or Business Expenses

**2% shareholders' health insurance:** Notice 2008-1<sup>11</sup> provides rules and examples on when a 2% shareholder-employee in an S corporation is able to claim the deduction for self-employed health insurance premiums. In short, the premiums must be paid by the corporation (either directly or indirectly),

## COMMENTATORS HAVE NOTED SOME OF THE UNINTENDED CONSEQUENCES OF THE NEW LAW.

and the amount paid on behalf of the shareholder-employee must be included in gross income. The amount is treated as equivalent to a partner's guaranteed payment and thus is not subject to Social Security or Medicare.

**Insurance costs of owner's spouse:** Two recent Tax Court cases dealt with the deduction for health insurance costs paid by a business or farm where the owner's spouse was the only employee. In both cases, the IRS denied a deduction under Sec. 162(a).

In *Eyler*,<sup>12</sup> the petitioner offered a verbal (unwritten) health plan. He obtained an insurance policy in his own name covering himself and his wife. He paid the premiums directly from his own personal funds. The Tax Court found for the IRS and denied the deduction.

In *Frahm*,<sup>13</sup> the petitioner established a written medical reimbursement plan. While he obtained an insurance policy in his name covering himself and his wife/employee, she paid the premiums from an individual checking account maintained in her name only. She also obtained and paid for a separate cancer insurance policy in her name and paid uninsured expenses from her personal funds. The business then reimbursed her

for all these expenses. In this case, the Tax Court found for the petitioner and allowed the deduction.

The conclusion to be drawn is that it is critical that the employee/spouse should use funds from his or her own individual account to pay for reimbursable health insurance expenses.

**Qualified performance-based compensation:** Rev. Rul. 2008-13<sup>14</sup> clarifies several unclear situations regarding "qualified performance-based compensation." Payments based "solely" on the attainment of performance goals do not count toward total employee remuneration in calculating excessive compensation under Sec. 162(m). The ruling states that payments made under an otherwise qualified performance-based plan are not considered qualified if paid solely because an employee is terminated without cause, an employee resigns for good reason, or an employee voluntarily retires. Generally, this clarification will not be applied to plans where the performance period begins on or before January 1, 2009, or the compensation is paid under a contract as in effect (without regard to renewals or extensions) on February 21, 2008.

## Sec. 163: Interest

The IRS ruled that a noncorporate limited partner's distributive share of the interest expense on indebtedness allocable to the partnership's trade or business of trading securities was investment interest under Sec. 163(d)(3) and was subject to the limitation on the deduction of investment interest under Sec. 163(d)(1).<sup>15</sup> The limitation applied because the limited

10 CCA 200812024 (2/8/08).

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

12 *Eyler*, T.C. Memo. 2007-350.

13 *Frahm*, T.C. Memo. 2007-351.

14 Rev. Rul. 2008-13, 2008-10 I.R.B. 518.

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

partner did not materially participate in the trading activity within the meaning of Sec. 469. In addition, because the degree of participation by each noncorporate partner of the partnership could limit the deductibility of the interest expense allocable to its trading business, the partnership must separately state this interest.

### **Sec. 165: Casualty Losses**

The Heartland, Habitat, Harvest, and Horticulture Act of 2008<sup>16</sup> was enacted on May 22, 2008, via override of a presidential veto. This act provides relief to owners of property destroyed by storms in Kansas on May 4, 2007. Affected property owners will have a five-year period to replace converted property (rather than two years). Substantially all of the use of the new property must be in the presidentially designated Kansas disaster area. This provision was made by extending the application of Section 405 of the Katrina Emergency Tax Relief Act of 2005<sup>17</sup> to the Kansas disaster area.<sup>18</sup> In addition, Sec. 1400S was modified to apply to losses arising on or after May 4, 2007, in the Kansas disaster area such that the \$100 and 10%-of-AGI (adjusted gross income) casualty loss limitations of Sec. 165 will not apply.<sup>19</sup>

### **Sec. 170: Charitable Contributions**

Notice 2008-16<sup>20</sup> provides rules for substantiation of lump-sum contributions made through the Combined Federal Campaign, United Way, or similar programs. Under Sec. 170(f)(17), all cash contributions must be substantiated with a bank record (cancelled check), credit card statement, or written confirmation from the donee organization. This ruling states that a deduction for this type of lump-sum contribution will not be allowed without a written communication from the organization stating the name(s) of the ultimate recipient organizations.

### **Sec. 213: Medical Expenses**

Rev. Rul. 2007-72<sup>21</sup> addresses the deductibility of whole-body scans and similar diagnostic procedures and tests when there is no recommendation or referral from a qualified medical professional. The ruling allows the cost of such procedures and tests to be deducted as a medical expense on Schedule A (to the extent they exceed 7.5% of AGI) provided they are wholly medical in nature and serve no other function.

### **Sec. 262: Personal, Living, and Family Expenses**

In *Richardson*,<sup>22</sup> the Sixth Circuit found that the taxpayers had tried to deduct personal living expenses through the use of a business trust and a charitable trust. The court held the trusts to be shams, lacking in economic substance, because the taxpayers continued to control the trusts' assets and were the sole beneficiaries. The taxpayers used the trusts as vehicles through which they improperly tried to deduct personal living expenses and charitable deductions for gifts that were made essentially to themselves.

### **Sec. 264: Certain Amounts Paid in Connection with Insurance Contracts**

Notice 2008-42<sup>23</sup> provides that a modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement will not be treated as a material change for purposes of Sec. 264(f). Under that provision, any material increase in the death benefit or other material change in the contract is treated as a new contract.

### **Sec. 691: Basis of Property Acquired from a Decedent**

In a private letter ruling,<sup>24</sup> the IRS ruled that gain from the sale of property after a decedent's death was not income in respect of a decedent. The decedent had

entered into a contract to sell property. The sale was originally intended to close prior to the decedent's death, but various unforeseeable uncertainties delayed the closing of the sale.

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

**Legislation:** For exchanges completed after May 22, 2008, Sec. 1031 nonrecognition of gain may apply to an exchange of stock in a mutual ditch, reservoir, or irrigation company if the company is organized under Sec. 501(c)(12)(A) and the shares of the company are recognized by the highest court in the state of the company's formation as constituting or representing real property or an interest in real property.<sup>25</sup>

**Private letter rulings:** The Service allowed nonrecognition treatment of gain under Sec. 1031(f) in a related-party exchange, provided that neither party disposes of the replacement properties within two years of receipt.<sup>26</sup>

The IRS also ruled<sup>27</sup> that a limited partnership's receipt of 100% of a partner's interests in a partnership that holds real property will be treated as receipt of property that is of like kind to real property disposed of by the limited partnership (LP). Since the LP will acquire 100% of the partner's interest in the partnership, the LP is treated as having acquired the real property assets of the partnership rather than having acquired a partnership interest from the partners. Under Rev. Rul. 99-6,<sup>28</sup> the partnership is considered to have terminated under Sec. 708(b)(1)(A) and made a liquidating distribution of its real property assets to its partners.

Finally, the Service ruled<sup>29</sup> that "development rights" that a corporation intended to acquire as replacement property would be considered of like kind to the relinquished property that the taxpayer owns and intends to dispose of.

16 Heartland, Habitat, Harvest, and Horticulture Act of 2008, P.L. 110-234.

17 Katrina Emergency Tax Relief Act of 2005, P.L. 109-73.

18 Heartland, Habitat, Harvest, and Horticulture Act of 2008, Section 15345.

19 *Id.*

20 Notice 2008-16, 2008-4 I.R.B. 315.

21 Rev. Rul. 2007-72, 2007-50 I.R.B. 1154.

22 *Richardson*, 509 F.3d 736 (6th Cir. 2007).

23 Notice 2008-42, 2008-15 I.R.B. 747.

24 IRS Letter Ruling 200744001 (11/2/07).

25 Sec. 1031(i).

26 IRS Letter Ruling 200820017 (5/16/08).

27 IRS Letter Ruling 200807005 (2/15/08).

28 Rev. Rul. 99-6, 1999-1 C.B. 432.

29 IRS Letter Ruling 200805012 (2/1/08).

## Sec. 1091: Loss from Wash Sales of Stock or Securities

Rev. Rul. 2008-5<sup>30</sup> provides that if an individual sells stock or securities at a loss and causes his or her IRA or Roth IRA to purchase substantially identical stock or securities within a specified period (30 days before or 30 days after the date of sale), the loss on the sale of the stock or securities is disallowed under Sec. 1091. However, the ruling also holds that the individual's basis in the IRA or Roth IRA is not increased under Sec. 1091(d).

## Sec. 1211: Limitation on Capital Losses

In *Pavlosky*,<sup>31</sup> the Fifth Circuit determined that a taxpayer's 2001 capital loss from the sale of certain stock obtained through the exercise of an incentive stock option (ISO) in 2000 did not give rise to a net operating loss (NOL) for purposes of the regular income tax or the alternative tax NOL deduction. The court held that once the taxpayers exercised the ISO, they held the stock as a capital asset and therefore the loss on the stock was a capital loss that could not be offset against ordinary income and did not give rise to a regular tax NOL or AMT NOL that could be carried back to previous years.

## Sec. 1221: Capital Asset Defined

**Accounts receivable:** The IRS withdrew proposed regulations<sup>32</sup> relating to circumstances in which accounts or notes receivable are "acquired . . . for services rendered" within the meaning of Sec. 1221(a)(4).<sup>33</sup>

The 2006 proposed regulations had come under attack by mortgage providers, who claimed that the proposed regulations would treat notes received for providing loans to customers as capital assets. Under the proposed regulations, notes and accounts receivable that are obtained in exchange for more than a *de minimis* amount of consideration, other

than property or services rendered (e.g., the service of providing a loan), would not have been treated as within the Sec. 1221(a)(4) capital asset exception. As such, if there were a loss, the limitations on capital losses would also have been applicable.

**Musical works:** The IRS issued a temporary regulation on the "time and manner" for making an election under Sec. 1221(b)(3) to treat gain or loss from the sale or exchange of certain musical compositions or copyrights in musical works as gain or loss from the sale or exchange of a capital asset.<sup>34</sup> As a result, a composer who sells his or her copyrighted composition in a sale and makes this election will pay tax at the lower rates that apply to capital gains instead of at ordinary income tax rates.

The exception/election was originally a temporary measure provided by the Tax Increase Prevention and Reconciliation Act of 2005.<sup>35</sup> It was later made permanent by the Tax Relief and Health Care Act of 2006.<sup>36</sup>

## Sec. 1222: Other Terms Relating to Capital Gains and Losses

The Ninth Circuit held<sup>37</sup> that a termination payment received by a retiring insurance agent was taxable as ordinary income, not capital gain. Because his agreement with the insurance company was only a contract for services and reserved all property rights in the insurance company, the taxpayer did not have any property rights that he could sell under the express terms of the agreement. Therefore, the court held that the termination payments were ordinary income.

## Sec. 1233: Gains and Losses from Short Sales

The Fifth Circuit affirmed<sup>38</sup> the Service's disallowance of a short-term capital loss of \$102.6 million that arose out of a series of "son of boss" short-sale transactions.

Son of boss transactions are a variation of BOSS (bond and option sales strategy) shelter transactions that generate artificial tax losses that are used to offset legitimate income from other transactions. There are several versions of the son of boss transaction, including a short-sale variant and an offsetting option variant. In the short-sale variant, the loss claimed is dependent on the obligation to replace the borrowed securities in a short sale being treated as a contingent liability that is not a liability of the partnership for purposes of Sec. 752. The court held that the obligation to close a short sale is a liability for purposes of Sec. 752, thus eliminating the claimed losses on the transactions.

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## EditorNotes

The authors are all members of the AICPA's Individual Income Tax Technical Resource Panel. Ellen Cook is a professor in the College of Business Administration at the University of Louisiana in Lafayette, LA. Sabrina Covington is a partner in Harvey, Covington & Thomas, LLC, in Altamonte Springs, FL. Jonathan Horn is a sole practitioner specializing in taxation in New York, NY. Michelle Musacchio is president of Fit Money CPA in Louisville, KY. Annette Nellen is a professor at San Jose State University in San Jose, CA. Darren Neuschwander is a shareholder in Neuschwander, Faircloth & Hardy, P.C., in Robertsdale, AL. Joseph W. Walloch is a professor of advanced taxation at the University of California, Riverside, CA. For more information about this article, please contact Ms. Cook at [ecook@louisiana.edu](mailto:ecook@louisiana.edu).

30 Rev. Rul. 2008-5, 2008-3 I.R.B. 271.

31 *Pavlosky*, No. 06-20896 (5th Cir. 12/4/07).

32 REG-109367-06.

33 Announcement 2008-41, 2008-19 I.R.B. 943.

34 T.D. 9379.

35 Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222.

36 Tax Relief and Health Care Act of 2006, P.L. 109-432.

37 *Trantina*, 512 F.3d 567 (9th Cir. 2008).

38 *Kornman & Assocs., Inc.*, 527 F.3d 443 (5th Cir. 2008).