

RECAP OF SIGNIFICANT DEVELOPMENTS THAT OCCURRED IN THE THIRD QUARTER 2007

A number of important tax developments occurred in the past three months which may affect you, your family and your livelihood. These developments are summarized below. Please call us for more information about any of these developments and what steps should be implemented to take advantage of favorable developments and to minimize the impact of those which are unfavorable.

- **Help for taxpayers who lose their homes through foreclosure.**

The IRS implemented a new "Frequently Asked Questions" (FAQs) section on its website devoted to taxpayers facing losing their homes due to foreclosure. It also reassured homeowners that, while mortgage workouts and foreclosures can have tax consequences, special relief provisions are in place to "reduce or eliminate the tax bite for financially strapped taxpayers who lose their homes." At the same time, legislation is working its way through Congress to provide tax relief for struggling homeowners.

- **First two "transactions of interest" identified for tax shelter disclosure purposes.**

The IRS has identified the first two "transactions of interest" subject to tax shelter disclosure requirements. One is built-on contributions of certain real property interests to charities and involves inflated valuations, and the other deals with grantor trusts, which are purportedly terminated and recreated to generate large losses.

- **Tax brackets, personal exemptions, standard deduction and other tax items increase for inflation.**

Individual tax rate brackets, personal exemptions, standard deductions and other tax items are adjusted annually for cost-of-living increases. The IRS has released the 2008 figures, based upon inflation data. The personal exemption increases from \$3,400 for 2007 to \$3,500 for 2008 and the standard deduction for a married couple filing jointly increases from \$10,700 for 2007 to \$10,900 for 2008. Adjustments to the tax rate schedules also will cause more income to be taxed at lower rates.

- **Regulations would prevent ordinary loss on abandoned securities.**

Under current law, if a security which is a capital asset becomes worthless during the tax year, the loss is treated as from the sale or exchange of a capital asset - that is, as a capital loss - on the last day of the tax year. Even so, the IRS has learned some taxpayers have taken the position that a loss from the abandonment of a security is not subject to this loss characterization rule. In other words, an ordinary loss can be claimed. An ordinary loss is more valuable than a capital loss because it can offset ordinary income (like compensation) whereas capital losses are allowed only against

capital gains and \$3,000 of ordinary income. The IRS has issued proposed regulations which would subject abandoned securities to the loss characterization rule which treats losses from abandoned securities as capital losses in most cases. The regulations would apply to securities abandoned after final regulations are issued.

■ **IRS issues comprehensive guidance on cafeteria plans and flexible spending accounts.**

The IRS has issued proposed regulations on cafeteria plans - employee benefit plans which allow employees to make a choice between receiving taxable cash compensation or tax-free employee benefits - and flexible spending accounts (FSAs). The regulations generally would be effective after 2008, but taxpayers may rely upon them until final regulations are issued. The regulations explain the types of qualified benefits a cafeteria plan may offer, the extent to which a plan may offer a grace period for incurring expenses for qualified benefits, rules for making, revoking and changing elections and other important matters. A whole section of the proposed regulations is devoted to FSAs. In general, a FSA is a benefit designed to reimburse employees for expenses incurred for certain qualified benefits, up to a maximum amount not substantially in excess of the salary reduction and employer flex-credits allocated for the benefit.

■ **Teachers can easily escape the tough deferred compensation rules.**

Teachers who work nine or ten months during the school year often are paid (or may have the choice to be paid) over a period of twelve months. In a news release and frequently asked questions (FAQs) posted on its website, the IRS has reassured such teachers they will not become victims of the Tax Code's draconian deferred compensation rules. These rules could cause a teacher to be taxed before receiving some of his/her pay. However, under the regulations, teachers can easily avoid the problem. For example, take the case of a teacher who earns compensation from September 15 of one year through June 30 of the next year. The teacher could elect to defer compensation earned during that period on any date before September 15 of the first year without running afoul of the deferred compensation rules, but only if no amount is deferred beyond October 31 of the next year. No particular form is necessary for the election; it does not have to be made each year if the arrangement provides that a pre-existing election remains in place until the employee changes it; and, the election does not have to be filed with the IRS.

■ **Court invalidates regulations, and holds that stipends paid to medical residents were exempt from FICA.**

A district court has held that stipends paid by the Mayo Foundation to medical residents were exempt from FICA under the FICA student exception. In so holding, the court invalidated IRS regulations which would have disqualified medical residents for the student exception. The case has important ramifications for the many teaching hospitals and their residents. The decision however, does not affect the income tax aspects of medical residents' stipends. It is well settled they are not excludible.

- **“Disregarded entities” to pay their own employment and excise taxes under final regulations.**

The IRS has issued final regulations treating single-owner eligible entities, which are disregarded entities (disregarded as separate entities from their owners), and qualified subchapter S subsidiaries as separate entities for employment tax and related reporting requirements. They also treat these disregarded entities as separate entities for certain excise taxes reported on Forms 720, 730, 2290, and 11-C, as well as for excise tax refunds or payments claimed on Form 8849 and excise tax registration on Form 637. The regulations for employment taxes will apply to wages paid on or after January 1, 2009. The regulations for excise taxes will apply to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.

- **IRAs can buy shares in trusts invested in gold or silver without triggering collectibles tax.**

In private-letter rulings, the IRS has concluded the acquisition of shares of a trust invested in gold or silver by either an individual retirement account (IRA) or an individually-directed account under a qualified retirement plan won't be considered the acquisition of a collectible. The acquisition by an IRA or an individually-directed account under a qualified retirement plan of any collectible is treated as a distribution from the IRA or account in an amount equal to the cost to the IRA or account of the collectible. Subject to exceptions, a collectible is any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage or any other tangible personal property specified by the IRS for this purpose. Thus, the shares purchased by the IRA or individually-directed account in the trust invested in gold or silver won't be treated as distributed. This is so even though the trust shares are designed to mirror the physical market in gold or silver as the case may be.

- **New list of rural renewal counties where expanded work opportunity tax credit is available.**

In the instructions for Form 8850 (Rev. June 2007), the IRS issued a list of rural renewal counties for work opportunity tax credit (WOTC) purposes. Employers who hire qualifying individuals residing in these counties are eligible to claim a WOTC for individuals beginning work after May 25, 2007. The “designated community resident” category is unique in that it does not carry detailed income - or needs- oriented requirements. Hiring an individual who lives in the right place, is the right age and meets the other requirements can generate a WOTC regardless of the individual's income status or whether the individual is a blue-collar or white-collar worker.

- **New relief for late S corporation elections.**

New IRS guidance provides an additional simplified method for taxpayers to request relief for late S corporation elections. Specifically, it allows small businesses which missed filing Form 2553, Election by a Small Business Corporation, before filing their first Form 1120S, U.S. Income Tax Return for an S Corporation, to file both forms simultaneously, under certain circumstances. It also contains an additional simplified method for taxpayers to request relief for a late S corporation election and a late corporate classification election intended to be effective on the same date.

- **Exclusion of gain on destroyed homes.**

The IRS has stated a home must be totally destroyed for gain on a deemed sale of the property to be excluded under the home sale exclusion rules. The IRS also said a disaster-damaged home which must be torn down before it can be rebuilt at a cost exceeding its pre-disaster value qualifies as destroyed for this purpose.

- **Developments affecting non-qualified deferred compensation.**

The IRS has extended transition relief for complying with the plan document requirements for non-qualified deferred compensation (NQDC) plans until December 31, 2008. It has also provided guidance and limited relief on several other issues, including the requirements for the time and form of payment. In addition, the IRS announced it will soon approve a voluntary compliance program.

- **Boosted 2007 housing cost allowances for those working abroad in high-cost areas.**

Recent IRS guidance effectively increases the maximum housing cost exclusion for U.S. citizens and residents working abroad in specified high-cost locations. The increases are based upon geographic differences in foreign housing costs relative to U.S. housing costs.

- **New guidance on tax-sheltered 403(b) annuities.**

IRS has issued comprehensive guidance on section 403(b) tax-sheltered annuities. Tax-sheltered 403(b) annuities offer benefits similar to those under a qualified employee plan. Tax is not imposed when the annuity is bought, but is deferred until payments are received. These annuities may be bought only for common law employees of certain exempt educational, charitable, religious, etc., employers and by or for certain self-employed ministers. The guidance, in the form of final regulations, covers numerous statutory and administrative changes, which have occurred in this area during the past 40 years. Among other items, the final regulations provide for three specific kinds of non-taxable exchanges or transfers of amounts in section 403(b) contracts: (1) A mere change of investment within the same plan (contract exchange); (2) a plan-to-plan transfer, i.e., a transfer to an employer plan receiving the exchange; or (3) a transfer to purchase permissive service credit (or a repayment to a defined benefit governmental plan).

- **Court stands firm in reversing decision which would have let awards go untaxed.**

The U.S. Court of Appeals for the District of Columbia Circuit has denied a request by a losing taxpayer for a rehearing by the full court of its reversal of its controversial decision that taxing awards for non-physical personal injury unrelated to lost wages or earnings was unconstitutional. Thus, it let stand its earlier revised holding (on rehearing) that awards for non-physical personal injury unrelated to lost wages or earnings are taxable.

- **New system for getting an employer identification number instantly.**

The IRS has announced taxpayers can now request an Employer Identification Number (EIN) through a Web-based system, which instantly processes requests and generates identification numbers in real time. This is a vast improvement for taxpayers who are starting a business and need an EIN. In the past, they were told to file an application for an EIN four to five weeks before the number was needed.

- **Simplified per diem rates changed for post-September 30 business travel.**

The IRS has issued "high-low" simplified per diem rates for post-September 30, 2007, travel. The high-cost area per diem decreases \$9, and the low-cost area per diem increases \$4, from the prior simplified per diems. An employer may pay a per diem amount to an employee on business-travel status instead of reimbursing actual substantiated expenses for away-from-home lodging, meal and incidental expenses (M&IE). If the rate paid does not exceed IRS-approved maximums, and the employee provides simplified substantiation, the reimbursement is not subject to income or payroll tax withholding and is not reported on the employee's Form W-2. In general, the IRS-approved per diem maximum is the GSA per diem rate paid by the Federal government to its workers on travel status. This rate varies from locality to locality. Instead of using actual per diems, employers may use a simplified "high/low" per diem, under which there is one uniform per diem rate for all "high-cost" areas within the continental U.S. (CONUS), and another per diem rate for all other areas within CONUS. Under the optional high/low method for post-September 30, 2007 travel, the high-cost-area per diem is \$237 (\$9 less than the previous rate), consisting of \$179 for lodging and \$58 for M&IE. The per diem for all other localities is \$152 (\$4 more than the previous rate), consisting of \$107 for lodging and \$45 for M&IE.

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