

# Newsletter

Tax and Accounting Information and News for our Clients

## 2008 Tax Law Changes

By David Mellem, EA

*We have had a few tax law changes so far this year and a couple in late December last year. The outlook is good that we will have another one this year sometime after the elections and the end of the year. We are also affected by changes brought about by IRS regulations in some areas. This article provides an overview of these items.*



### Section 179 Increase

The Sec. 179 deduction increased to \$250,000 (up from the indexed amount of \$128,000 that was slated to apply for 2008). This amount is reduced if total assets eligible for the Sec. 179 purchased during the year exceed \$800,000. There are no special rules for this Sec. 179 expense except that the assets have to be purchased and placed in service during the calendar year 2008. For example, this increased Sec. 179 expense is available for new or used property, and it is not available for property used in rental activities.

### Bonus Depreciation Is Back

We now have a one-year revival of the fifty-percent bonus depreciation. This is available in the same manner as it was back in 2001-2004. As a quick review, the property must be new (its first use has to be with the taxpayer), have a MACRS class life of twenty years or less, and must be placed in service during the calendar year 2008.

Just as before, the fifty-percent bonus depreciation is the default. If a taxpayer does not want to deduct the fifty-percent bonus depreciation, an "election out" must be attached to the tax return.

The listed property limits are increased for vehicles that qualify for this fifty-percent bonus depreciation. The limit is increased by \$8,000 for the first year, raising the limit from \$2,960 to \$10,960 (assuming 100% business use) for passenger automobiles and from \$3,160 to \$11,160 (assuming 100% business use) for trucks and vans, including SUVs and minivans.

### First-Time Homebuyer Credit

This title might be better termed a "Loan" instead of a "Credit" since it is a refund that a taxpayer can receive but has to repay. Here are the details:

This refundable credit is equal to ten percent of the purchase price of a qualifying taxpayer's principal residence, with a maximum credit not to exceed \$7,500 (\$3,750 for MFS). The amount of the credit is reduced for a taxpayer with a modified AGI of over \$75,000 (\$150,000 for MFJ). The reduction is prorated over a \$20,000 range with the credit entirely phased out for taxpayers with modified AGIs of \$95,000 (\$170,000 for MFJ). "Modified AGI" is AGI plus amounts excluded under Sec. 911, 931, or 933.

The credit is only available to properties purchased on or after April 9, 2008 and before July 1, 2009. Only for purposes of this credit, a taxpayer can elect to treat the purchase of a qualifying residence after December

31, 2008 and before July 1, 2009 as if the residence was purchased on December 31, 2008. This option will give the taxpayer the credit on the 2008 return but will also start the recapture period (discussed later) sooner.

A “first-time homebuyer” is a taxpayer (and spouse if the taxpayer is married) who has had no present ownership interest in a principal residence during the three-year period ending on the date of the purchase of this principal residence.

A “principal residence” is defined as a principal residence for purposes of the sale of residence exclusion under Sec. 121.

A “purchase” is defined as the acquisition of a principal residence, but does not include:

1) Property acquired from a related party as found in Sec. 267 or 707(b) except that paragraph Sec.

The credit is not allowed if:

1) The taxpayer has received a credit under Sec. 1400C (first-time homebuyer in DC) for the same year or any earlier year,

2) The residence is financed by the proceeds of a qualified mortgage issue of which the interest is exempt from tax,

3) The taxpayer is a nonresident alien,

4) The taxpayer disposes of the residence before the close of the taxable year of its purchase, or

5) The taxpayer (and spouse, if married) ceases to use the property as a principal residence before the end of the taxable year of its purchase.

Unmarried joint purchasers of a home split the credit according to regulations IRS is to issue. The total credits among all the joint owners cannot exceed \$7,500.

of the purchase of the principal residence.

If the taxpayer ceases to use the property as a principal residence (such as by establishing a new principal residence), the balance of the credit that has not been recaptured is recaptured on the return for the year of the cessation.

If a taxpayer disposes of the property before the end of the recapture period, the taxpayer is required to recapture any credit not already recaptured. The recapture due to a disposition is limited to the taxpayer’s gain on the disposition of the property.

When this gain is calculated, the taxpayer is required to reduce the basis in the property by the credit that has not already been recaptured.

The recapture rules do not apply in the following situations:

1) The taxpayers death. In this case the recapture does not apply to any year ending *after* the year of the death.

2) Involuntary, conversion. Recapture does not apply if the residence is involuntarily converted (cf. Sec. 1033) and the taxpayer acquires a new principal residence during the two-year period beginning on the date of the disposition or cessation of use as a principal residence. The recapture rules are carried over to this new property and continue as if the new property were the property used to claim the original credit.

3) Transfers to spouse or incident to divorce. The recapture provisions stay with the property in these cases. The spouse or ex-spouse who receives the property has to

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267(d) is modified to include only a spouse, ancestors, and lineal descendants, or

2) Property acquired that has a basis determined in whole or in part by reference to the adjusted basis of the property in the hands of the person it was acquired from. (This provision knocks out property received in gifts).

A “purchase” includes the construction of the residence. If a taxpayer constructs a residence, the taxpayer is deemed to have “purchased” the property on the date the taxpayer first occupies such residence.

## Recapture of the Credit

As stated earlier, this credit is really more like a loan. The taxpayer who claims this credit faces a recapture tax of the entire credit amount spread over the recapture period of fifteen years. This recapture tax increases the taxpayer’s income tax each year by an amount equal to 1/15th (6.67%) of the credit amount. The recapture continues for fifteen years until the entire credit is recaptured unless certain events accelerate the recapture. The recapture begins with the second year following the year

follow the recapture rules starting with the year after the transfer.

The credit is deemed to be received equally by each spouse when it is claimed on an "MFJ" return. Therefore if an MFJ couple file separate returns in any future year, each spouse is subject to the recapture provisions based on fifty percent of the credit.

A taxpayer must file a return to report the recapture tax even if the taxpayer does not otherwise have a filing requirement.

### **Increase in Standard Deduction for Real Property Taxes**

Only for the tax year beginning in 2008 and 2009, the standard deduction for individuals is increased by the amount of real property taxes paid by the taxpayer, but not more than \$500 (\$1,000 for MFJ returns). This is a one-year deduction only, but these short term provisions often get extended to one or more future years.

### **Gain From Sale of Principal Residence Allocated to Nonqualifying Use Not Excluded from Income**

This provision is applicable to sales after December 31, 2008. It basically denies a taxpayer the right to use the Sec. 121 exclusion for the gain from the sale of the taxpayer's principal residence to the extent the gain is due to periods in which the residence was used for a nonqualifying purpose (rental, business, etc.) after December 31, 2008.

The new provisions state the exclusion does not apply to "so much of the gain from the sale or

exchange of property as is allocated to periods of nonqualified use."

The gain that relates to the nonqualified use is the prorated portion of the gain calculated by taking the aggregate periods of nonqualifying use divided by the total ownership period of the property. In other words, divide the nonqualifying use time by the total ownership time to determine the nonqualifying percentage. Multiply this percentage by the total gain to arrive at the nonqualifying gain.

The "period of nonqualifying use" starts *no earlier* than January 1, 2009 (therefore ignoring prior years' usage). It also does not include:

- 1) Any portion of the five-year period before the sale date which is after the last date that the property was used by the taxpayer or spouse as a principal residence. For example, if the taxpayers owned and lived in the property for twenty years, moved out and then rented it out for three years before its sale date, the three years are *not* treated as "nonqualifying use."
- 2) Any portion of the special "up to ten years" period that is ignored for purposes of the Sec. 121 exclusion when the taxpayer or spouse is on qualified official extended duty.
- 3) Any period of temporary absence (not more than two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the regulations.

**The Mortgage Forgiveness Debt Relief Act of 2007** was enacted in late December 2007 and applies to qualified debt forgiven in 2007, 2008, or 2009. Usually, debt that is forgiven or cancelled by a lender must be treated as taxable income, but the recent legislation allows taxpayers to exclude from income

certain cancelled mortgage debt secured by a principal residence. The provision to exclude cancelled mortgage debt from income applies only to the portion of the debt that was used to buy, build, or improve the taxpayer's residence.

**Mortgage insurance premiums** with respect to mortgage insurance contracts issued after 2006 remain deductible through 2010 as the result of extending legislation enacted by Congress in late December 2007.

**Volunteer firefighters and emergency medical responders** are allowed up to \$30 per month as nontaxable income, including exemption from FICA. This provision is effective for calendar years 2008-2010.

**Penalties for late-filed partnership returns** increased to \$85/month/partner, with a maximum of twelve months (up from the former \$50/month/partner, with a maximum of five months). This change was effective with the 2007 partnership tax returns. The base penalty increases from the \$85 amount to \$86 for 2008 partnership tax returns. The one-year extra \$1 is an offset to the Act that exempted Virginia Tech victims and families from tax on damages received.

**Penalties for late-filed S Corporation returns** are imposed at \$85/month/shareholder, up to a maximum of twelve months.

This change was effective with the 2007 S corporation tax returns.

**The Kiddie tax** for 2008 tax returns applies to children under the age of nineteen and to full time students under the age of twenty-four. There is no requirement that the child be a dependent of anyone. The Kiddie tax will not apply if the child's

earned income is more than fifty percent of the child's support for the entire year, but the Kiddie tax can still apply if the child's unearned income exceeds fifty percent of the child's support.

## Regulation Changes

### Change in Length of Filing Extensions for Some Entity Returns

IRS regulations have changed the filing extension period for partnerships (Form 1065 series) and trusts and estates (Form 1041 series). The new extension period is only five (5) months (previously six months) starting with returns which have unextended due dates on or after January 1, 2009. This change affects partnerships, trusts, and estates with tax years ending in September 2008 or later (such as calendar year returns).

As you know, Congress has set various deadlines for filing of income tax returns including the April 15 deadline for individuals, partnerships, and trusts. IRS has granted taxpayers the right to file extensions which give taxpayers more time, typically a maximum of six months or some other period followed by an additional amount if there is a valid reason. Over the past few years IRS has changed some of the extensions, such as giving partnerships a flat automatic six months instead of the former automatic three months' followed by up to three more months if the partnership had a valid reason.

One of the difficulties individual taxpayers have had is getting the information from pass through entities—in particular partnerships, estates, and trusts—in time to complete their individual income tax returns.

On June 24, 2008, IRS changed the extension time periods for some returns. TD 9407 contains the regulations that made these changes. As stated above, partnerships (Form 1065 series) and trusts and estates (Form 1041 series) now have a five-(5) month extension limitation (previously this was six months). This brings the extended due date for calendar year Forms 1065 and 1041 to September 15, the same date as corporations. The extension time remains at six (6) months for partnerships that keep their records and books of account outside the United States and Puerto Rico.

This regulation is technically effective for all returns due on or after July 1, 2008, but there is a provision in the regulation that says taxpayers can delay its effective date to returns due on or after January 1, 2009.

The extension time limit for corporation returns did not change. Because they have unextended due dates of March 15, their six-

business starts. If the total startup costs exceed \$50,000, this \$5,000 limit is reduced dollar for dollar. Any startup costs in excess of the elected amount can be amortized using a straight-line method over a period of fifteen years on a monthly basis if the taxpayer elects such. If no election is made, the startup costs are capitalized and sit on the books until the entity terminates.

Taxpayers incurring organizational expenses under IRC Sec. 709 (partnerships) or IRC Sec. 248 (corporations) can elect to deduct up to \$5,000 in the year the business starts. If the total organizational expenses exceed \$50,000, this \$5,000 limit is reduced dollar for dollar. Any organizational expenses in excess of the elected amount can be amortized using a straight-line method over a period of fifteen years on a monthly basis if the taxpayer elects such. If no election is made, the organizational expenses are capitalized and sit on the books until the entity terminates.

Until recently, the election to deduct

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month extensions bring their extended due dates to September 15, which is still one month prior to the extended due dates for calendar year individual income tax returns.

### Change in Procedure to Elect to Deduct Startup and Organization Costs

Taxpayers incurring startup costs under IRC Sec. 195 can elect to deduct up to \$5,000 in the year the

and/or amortize startup costs and organizational expenses was made by attaching a statement to the tax return identifying the costs and formally making the election.

Now IRS has released new regulations regarding this election. The new regulations state the taxpayer makes the election by merely deducting the expenses (subject to the limitations mentioned

above) on the tax return for the first year the business starts. There is no longer a requirement for a written statement.

In the event of an audit, taxpayers still need to be able to show the items that make up the startup costs and organizational expenses as well as the amount deducted on the return to verify the proper limits have been applied.

## **New Regulations Regarding Form 8332 Including Revocability**

Before we get into the changes involving the definition of “custodial” parent and the revoking of a Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents), let us briefly review the old rules.

Back in 1984, Congress changed the rules involving a noncustodial parent’s right to claim a child as a dependent. The rules basically state the custodial parent has the right to claim the child. They further state the noncustodial parent can claim the child as a dependent when the custodial parent signs Form 8332 or a statement that says the same thing.

Divorce decrees often have a provision that states something such as: “(name of noncustodial parent) can claim (name of child) as a dependent for tax purposes for (identified years). Form 8332 generally states, “I will not claim \_\_\_\_\_ for the tax year \_\_\_\_.” The divorce decree wording we used here is not the same as the Form 8332 wording. Some taxpayers have used the divorce decree as the authority to claim the child even though the wording is different. The courts have generally enforced the

requirement to have a Form 8332 or similar statement.

Now IRS has released new regulations dealing with this issue. New Regulation 1.152-4 states the child is “the qualifying child of the parent with whom the child resides for a longer period of time during the taxable year ...”. It further states “if the child resides with both parents for an equal period of time, (the child is treated as the qualifying child) of the parent with the higher adjusted gross income.”

A noncustodial parent can claim the qualifying child if the custodial parent provides a proper release.

The “custodial parent” is now defined as “the parent with whom the child resides for the greater number of nights during the calendar year.” No longer will this be determined based on the number of days, but now it is based on the number of nights.

Further, a child is not considered residing with either parent starting with the date the child is emancipated under state law (reaches the age of majority). Therefore, a child who reaches the age of majority on or before the day after the half-way point of the year (normally July 3) will not be in the custody of the parents for more than half the year.

**Reside:** A child is deemed to reside with a parent if the child sleeps:

- 1) At the residence of that parent (whether or not the parent is present), or
- 2) In the company of the parent, when the child does not sleep at the parents residence (such as when on vacation together).

**Overlapping Night:** If the night overlaps two taxable years, such as December 31, the night is

counted towards the year it begins (December).

**Absences:** If the child does not reside with either parent for a night, the child is considered to be residing with the parent with whom the child would have resided for the night. This is true even if the parent with whom the child would have resided is away on military duty. If it cannot be determined which parent the child would have resided with for the night, the child is deemed to be residing with *neither* parent for that night.

**Equal Nights:** If the number of nights is equal; the parent with the highest AGI is the custodial parent for that year.

Exception: If a child resides with one parent for a greater number of days, but not a greater number of nights due to the parent’s nighttime work schedule, this parent is deemed to be the custodial parent. For this purpose, on school days, the child is deemed to be residing during the day with the primary residence registered with the school.

## **Release of Exemption to Noncustodial Parent**

As provided in the Internal Revenue Code, the new regulation permits the custodial parent to release the exemption to the noncustodial parent. However the method has changed slightly. The changes are partly due to the results of court cases and comments from the public and tax professionals.

The custodial parent’s release of the exemption must name the noncustodial parent and the year or years for which it is effective. A release that states “all future years” is treated as starting the year after the year the release is signed.

Therefore, if the release is to be effective earlier, it must specify the year.

This release can be accomplished by the use of Form 8332 or by the custodial parent providing a written declaration that is an unconditional release. A release is not unconditional if the release has any conditions, such as having to be current in support payments. This written declaration must conform to the substance of the Form 8332 and also must be a "document executed for the sole purpose of serving as a written declaration." The regulations further state: "A court order or decree of a separation agreement may not serve as a written declaration." Again, court cases have repeatedly denied the exemption to the noncustodial parent based on divorce decrees because their wording does not conform to the Form 8332, so this last statement in the regulation is understandable. Written declarations issued on or before July 2, 2008, are still effective in the future as long as they were effective when written.

The Form 8332 or written declaration must be attached to the noncustodial parent's return for each year the noncustodial parent claims the child.

## **Revoking Form 8332**

The custodial parent's release of the child's exemption to the noncustodial parent can be revoked. Previously, IRS gave a ruling that stated a revocation can be accomplished by the noncustodial parent not claiming the child *and* the custodial parent claiming the child. Now we have new rules.

The custodial parent can revoke a previous release by providing written notice of the revocation

to the noncustodial parent. This revocation is effective for the year designated on the revocation, but not earlier than the year after the year the revocation is provided to the other parent. In other words a revocation provided during 2008 can be effective no earlier than 2009. The custodial parent must make reasonable efforts to provide actual notice to the other parent and must keep the evidence of the delivery of the notice to the other parent. It may be a good idea to have the custodial parent mail the revocation using certified mail as proof of the fact that the revocation was sent and the date it was sent.

The revocation can be made using Form 8332 (as revised) or a written declaration that conforms to the substance of the Form 8332. The written declaration again must be a document executed for the sole purpose of serving as a revocation. A revocation that does not specify a year is not a valid revocation. A revocation that states "all future years" will be treated as effective the year following the year the revocation is properly executed and all future years.

The Form 8332 or written declaration revoking the release must be attached to the custodial parent's return for each year the custodial parent claims the child, as well as a copy of the revocation and evidence of delivery of the notice to the other parent or the reasonable efforts to provide actual notice.

These revocation procedures are effective to revoke any release of exemptions including ones from prior years. Written release declarations issued on or before July 2, 2008 can also be revoked under these new procedures.

The regulation has twenty examples that help in the understanding of these issues.

## **New Privacy Rules for Protecting Client Information**

IRS has released two regulations (301.7216-3 and 301.7216-3T) and Rev. Proc. 2008-35 dealing with a tax preparer's responsibility in protecting client information. IRC Sec. 7216(a) imposes criminal penalties on tax return preparers who knowingly or recklessly make unauthorized disclosures or uses of information furnished in connection with the preparation of an income tax return. A violation is a misdemeanor with a maximum penalty of up to one year imprisonment or a fine of not more than \$1,000, or both, plus the costs of prosecution. This means a violation is not just words but has a bite. IRC Sec. 6713 also imposes a civil penalty of \$250 per violation, up to \$10,000 for a calendar year.

One main exception to these penalties is when the taxpayer provides the tax preparer with written consent to the disclosure. This consent must be "knowing and voluntary" on the part of the taxpayer (Reg. 301.7216-3(a)).

## **Regulations**

The regulations generally prohibit a tax return preparer from disclosing a taxpayer's information prior to obtaining the taxpayer's written consent. The tax return preparer generally cannot make the providing of services contingent upon the taxpayer giving his or her consent to the disclosure. In other words the tax return preparer cannot deny services to a taxpayer just because the taxpayer did not give his or her consent to a disclosure

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request. There is an exception to making services contingent upon receiving the taxpayer's consent if the disclosure involves sharing the information with another tax return preparer for the purpose of performing services that assist in the preparation of, or provide auxiliary services in connection with, the preparation of the tax return of the taxpayer.

The consent statement must contain:

- 1) The names of the tax return preparer and the taxpayer.
- 2) The purpose of the disclosure including each specific type of product or service, such as balance due loans, mortgage loans, mutual funds, individual retirement accounts, and life insurance.
- 3) The tax return information that will be disclosed.
- 4) Other information as provided by IRS such as the information described below as found in Rev. Proc. 2008-35.

### **Other Rules Found in the Regulations:**

- 1) The consent cannot be retroactive.
- 2) A tax return preparer's request for consent to disclose or use tax return information for purposes of soliciting business unrelated to tax return preparation cannot be made after the completed tax return has been provided to the taxpayer for signature.
- 3) If a taxpayer declines to give consent to disclosure related to a disclosure for purposes of solicitation of business unrelated to tax return preparation, the tax return preparer cannot solicit from the taxpayer a consent for a purpose substantially similar to the rejected request.

4) A consent can specify it is valid for a specific period of time. If no time frame is mentioned, the consent is valid for one year from the date the consent is signed.

5) The taxpayer must be given a copy of the signed consent or be able to print out a copy of the consent.

### **Other Changes**

Following is the status for some of the extenders:

- Residential homeowner energy credit is reinstated for 2009 only but not for 2008.
- AMT again has a one-year patch for 2008. The exemption for MFJ is \$69,960 and \$46,200 for single/head of household.
- Ability to make a direct contribution to a charity from an IRA without recognizing the income or deduction is reinstated for 2008 and 2009.
- Teacher's deduction for classroom supplies.
- Tuition and fees deduction above the line.
- Sales tax deduction in lieu of state income tax deduction, and
- Depreciable life of fifteen years for qualified leasehold improvements and restaurant property.



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