

Kleinrock's Federal Tax Bulletin



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Inside....

Tax Highlights

The IRS reminds partnerships and S corporations of liberalized deductions due to Katrina Tax Act changes..... 3

Procedures for obtaining a waiver from the e-file requirements for corporations and tax-exempt organizations provided 5

The Eleventh Circuit holds that a modified buy-sell agreement was properly disregarded for determining the FMV of a decedent's shares..... 5

The Tax Court allocates part of a joint deficiency and penalties to an innocent spouse 6

The Tax Court holds that a taxpayer's disability doesn't excuse the imposition of penalties for early IRA withdrawals..... 3

According to the Tax Court, a partner cannot claim an ordinary loss deduction for the liquidation of a horse activity..... 4

In Brief 12

Code Section Index 12

For the full text of all documents discussed in this issue, go to www.Kleinrock.com.

2005 Year-End Planning; What's New in 2005 and 2006

Year-end tax planning season is here, which means another opportunity for practitioners to generate fees and goodwill by contacting clients and assessing their tax situations to see if they might benefit from some last minute planning.

Some clients may be affected by new tax law changes that take effect in 2005 or will take effect in 2006. For example, many businesses qualify for the new qualified production activities income deduction which takes effect in 2005. Also, provisions in the Katrina Emergency Tax Relief Act of 2005 may impact individuals and businesses affected by Hurricane Katrina. And new tax credits will be available to homeowners and businesses in 2006.

Additionally, if a client has more income in 2005 than expected, adjusting the client's tax withholding or estimated taxes to avoid the estimated tax penalty for 2005 may be in order.

(See TAX PLANNING, on p. 6)

Six-Month Extensions Available to Most Taxpayers in 2006

The IRS is streamlining extension procedures for individuals and most non-corporate entities, including partnerships and trusts, by providing these taxpayers with automatic six-month extensions of time in which to file their returns. Under temporary regulations issued earlier this month, eligible taxpayers can obtain a six-month extension by filing a single request.¹ As a result of the new regulations, which apply to extensions filed after December 31, 2005,² several existing forms are being eliminated.

Background

Corporations can file Form 7004 and receive an automatic six month extension of time to file Form 1120. Most other taxpayers can obtain a six-month extension only by filing one application for an initial extension of time and then filing a second extension. Requiring taxpayers to file two different forms to obtain the full six-month extension creates an unnecessary burden on taxpayers, the IRS said.

Automatic Six-Month Extension

The IRS has now replaced the two-step process and simplified the extension process by allowing certain taxpayers to file a single request for an automatic six-month extension of time to file returns. Under the regulations, most individuals and businesses

(See EXTENSIONS, on p. 2)

EXTENSIONS, from p. 1

will be able to request a full six-month tax-filing extension, beginning January 1, 2006. Neither a reason for the extension of time nor a signature on the extension form is required.

Individuals

Starting with 2005 tax returns, individuals can use Form 4868, Application for Automatic Extension of Time To File a U.S. Individual Income Tax Return, to get an automatic six-month extension of time. Form 2688, which taxpayers previously used to request a second extension, is now obsolete.

Partnerships, REMICs, and Trusts

The regulations allow partnerships, real estate mortgage investment conduits (REMICs) and certain trusts to file an automatic six-month extension of time on one application, the new Form 7004. As a result, Form 8736, Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts, and Form 8800, Application for Additional Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts, are now obsolete.

The preamble to the regulations note that because the six-month automatic extension is available for returns of pass-through entities, some taxpayers may not receive information returns from the pass-through entities that they need to complete their own income tax returns before those returns are due. For example, an individual taxpayer who obtains a six-month extension of time to October 15 to file Form 1040 may not receive a Schedule K-1 from a partnership in which the taxpayer holds an interest in until after the partnership files its Form 1065 on its extended due date of October 15.

The IRS noted that this situation could potentially result in taxpayers filing an increased number of amended income tax returns. The IRS is requesting comments as to whether pass-through entities should have a shorter extension period than their partners or shareholders. The IRS also encouraged pass-through entities that request an extension of time to minimize the impact that such an extension would have on their partners' or members' ability to timely file.

Certain Employee Plan Returns

The temporary regulations allow administrators and sponsors of employee benefit plans subject to Employee Retirement Income Security Act of 1974 (ERISA) to

report information concerning the plans and direct filing entities to use a new version of Form 5558, Application for Extension of Time To File Certain Employee Plan Returns, for an automatic two and one-half-month extension of time to file. Form 5558 no longer requires taxpayers to provide an explanation of the need for the extension of time to file or a signature.

Corporations

The regulations do not change the rules for filing extensions for corporate income tax returns. However, the regulations do change the title to and appearance of Form 7004, Application for Automatic Extension of Time To File Corporation Income Tax Return. Taxpayers filing certain other types of returns will now use Form 7004 to request an automatic six-month extension of time to file. The new Form 7004 will be titled, Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns.

Miscellaneous

Under the regulations, taxpayers that previously requested additional time to file certain excise, income, information, and other returns by submitting Form 2758, Application for Extension of Time To File Certain Excise, Income, Information, and Other Returns, may request an automatic six-month extension of time to file by filing the new Form 7004. Such taxpayers include those filing Form 1041, Form 706-GS(D), Form 706-GS(T), and Form 1042. Form 2758 is now obsolete.

The temporary regulations also allow donors who do not request an extension of time to file an income tax return to request an automatic six-month extension of time to file Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return by filing a new version of Form 8892, Payment of Gift/GST Tax and/or Application for Extension of Time to File Form 709. Form 8892 no longer requires an explanation of why the extension is necessary and no longer requires a signature.

Notes

1/ T.D. 9229, 70 Fed. Reg. 67,356 (11/7/05); REG-144898-04, 70 Fed. Reg. 67,397 (11/7/05); IR-2005-131(11/4/05).

2/ The regulations also apply to extensions to file certain 2004 returns of fiscal year taxpayers where those returns are due after December 31, 2005. although these taxpayers should continue to use 2004 extension forms, the IRS will grant a six-month extension if an extension request made on one of these forms would otherwise qualify under the regulations, except for the use of the specified form.

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TAX HIGHLIGHTS

Code Section 72

Imposition of Penalties Approved Despite Taxpayer's Disability

A partially disabled taxpayer who worked reduced hours as a result of her disability was liable for the penalty on early withdrawals from her IRAs; she did not qualify for the exception relating to disabled employees. *Thomas v. Commissioner*, T.C. Memo. 2005-258 (11/1/05).

Joyce Thomas worked for a semiconductor manufacturer to lay out computer chips. She also operated her own startup network marketing business. Joyce had bilateral tendonitis and carpal tunnel syndrome. She also suffered from periodic bouts of depression. Despite some changes to her job by her employer, Joyce's medical conditions limited her to working only four hours a day in 2000.

In 1999 and 2000, Joyce received distributions from her IRAs and reinvested the funds in non-IRA investments. During those years, she also did not file her tax returns or make estimated tax payments. In 2003, the IRS issued deficiency notices and determined that Joyce was liable for the 10 percent addition to tax on the early distributions from her IRAs as well as additions to tax for failure to file or pay estimated income tax.

Joyce argued that she qualified for the exception provided under Code Section 72(t)(2)(1)(A)(iii) for distributions attributable to an employee being disabled. She testified, at trial, that the state of her health slowed her down and required her to work part-time instead of full-time. Joyce also testified that she had filed tax statements, but could not recall when she filed the statements or the nature of those statements.

The Tax Court held that Joyce was liable for the 10 percent additional tax for the premature distributions from her IRAs as well as additions to tax for failure to timely file or pay estimated tax. The court rejected her argument that she qualified for the exception relating to disabled employees. The court noted that, for purposes of this exception, disability is defined as being unable to engage in any substantial gainful activity by reason of a physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. Although Joyce's health conditions required her to slow down and forced her to switch from full-time to part-time work, the court concluded that she was still able to engage in substantially gainful activity. Thus, Joyce did not come within the disability exception to the penalty for premature IRA distributions.

With respect to the addition to tax for failure to file and failure to make estimated tax payments, the Tax Court observed that, if Joyce had shown that she was so incapacitated that she could not file, she would have reasonable

cause to avoid the penalties. However, after considering the fact that Joyce was continuously employed by the manufacturer, ran her own business, and admitted that she had filed some tax statements, the court concluded that Joyce was not so incapacitated that she could not file her tax returns or pay the estimated taxes. Thus, she did not qualify for any exception from those penalties.

For a discussion of the 10 percent additional tax on early distributions from qualified retirement plans, see *Kleinrock's Analysis and Explanation*, Section 124.5.

Code Section 170

Katrina Emergency Relief Tax Act Can Benefit Partners and S Shareholders

The IRS is reminding partnerships and S corporations with tax years ending after August 27, 2005, that two sections in the Katrina Emergency Tax Relief Act of 2005 could affect their tax years beginning in 2004. Announcement 2005-84, 2005-48 I.R.B. ____.

The IRS is reminding partnerships and S corporations with tax years ending after August 27, 2005, that changes in the Katrina Emergency Tax Relief Act of 2005 (the Act) could affect their tax year beginning in 2004. The Act liberalizes the rules relating to deductions for certain cash and food contributions made between August 28 and December 31, 2005.

Under the Act, cash contributions made by a partnership during the period beginning on August 28, 2005, and ending on December 31, 2005, to charitable organizations qualify for the suspension of certain limitations on deductions. For individual partners, their distributive shares of these qualified contributions are not limited either by the 50 percent adjusted gross income limitation or the limitation on overall itemized deductions. For this purpose, an individual partner's deduction for qualified cash contributions is allowed to the extent the individual's adjusted gross income (computed without regard to any net operating loss carryback) exceeds the deduction for other charitable contributions.

For corporate partners, their distributive shares of the qualified contributions are not subject to the 10 percent taxable income limitation. Under the Act, a corporate partner's deduction for qualified cash contributions is allowed to the extent the corporation's taxable income, as computed under Code Section 170(b)(2), exceeds the deduction for other charitable contributions. Qualified contributions passed through to corporate partners are limited to contributions for relief efforts related to Hurricane Katrina.

Further, the Act temporarily extends the enhanced deduction for certain charitable contributions of food inventory under Code Section 170(e)(3) to contributions by partnerships and S corporations. The deduction is limited to donations of food inventory to certain charitable

organizations for the care of the ill, needy, and infants during the period beginning on August 28, 2005, and ending on December 31, 2005. The food must meet all the quality and labeling standards imposed by federal, state, and local laws and regulations.

For this purpose, the amount of the charitable contribution for donated food inventory is the lesser of: (a) the basis of the donated food plus one-half of the appreciation (gain if the donated food were sold at fair market value on the date of the gift) or (b) twice the amount of basis of the donated food. The deduction for contributions of food inventory may not exceed 10 percent of the partner's or shareholder's aggregate net income for the tax year from all businesses from which food inventory contributions were made, including the partner's or shareholder's share of net income from the partnerships or S corporations that made the food inventory contributions.

The announcement also provides guidance on reporting for partnerships and S corporations for cash contributions and contributions of food inventory. This announcement also is intended to supplement the 2004 instructions for Forms 1065 and 1120S.

For an overview of percentage limitations on charitable contributions, see *Kleinrock's Analysis and Explanation*, Section 42.13; for a discussion of the limitations on charitable contributions for S corporations, see *Kleinrock's Analysis and Explanation*, Section 304.2.

Code Section 469

No Ordinary Loss Deduction Allowed On Liquidation of Horse Activity

A taxpayer could not treat losses attributable to the disposition of his interest in a horse breeding and racing partnership as non-passive losses. *Ramsburg v. Commissioner*, T.C. Memo 2005-252 (10/31/05).

In 1980, Jacob Ramsburg and Carroll Stottlemeyer formed a general partnership known as Kildare Timmy to engage in the horse business. When Kildare Timmy was formed, its business activities, except for some minor horse breeding activities, were limited to racing horses. The partnership hired trainers to maintain, care for, and train its race-horses. In 1986, Kildare Timmy became more involved in horse breeding activities. Kildare Timmy's broodmares were maintained and cared for by Jacob at stables located on his farm. Until 1995, Carroll generally performed day-to-day management services for Kildare Timmy. He did not receive any salary from Kildare Timmy or increases in his Kildare Timmy capital account in return for these services.

Beginning in 1995, Carroll became ill and Jacob assumed his day-to-day management role. Ultimately Carroll concluded that he should withdraw from the partnership. Carroll and Jacob decided to terminate Kildare Timmy.

In December 1997, Jacob proposed terms for terminating Kildare Timmy, which included discontinuing the

purchases of any more horses, winding up the business with Jacob assuming responsibility for the checking account, purchasing all the horses and equipment at book value, and assuming all the partnership's liabilities. Carroll agreed to the terms. In 1998, Kildare Timmy distributed all of its assets to Jacob including seven race horses and 12 breeding horses, the balance in the partnership's checking account, and certain stud rights. Jacob transferred the horses to a separately owned sole proprietorship also engaged in racing and breeding horses.

On his 1998 individual return, Jacob claimed an ordinary loss of \$809,668. This loss represented losses which had been suspended over the years that Jacob claimed he could now recognize because he disposed of the activity conducted by Kildare Timmy. Subsequently, Jacob sought refunds for prior years as a result of carrying back the net operating loss arising from 1998. The IRS disallowed the loss stating that Jacob had not proved that he was entitled to the loss.

Under Code Section 469(g)(1), a taxpayer who disposes of an interest in a passive activity may deduct suspended losses only if, among other things, the disposition is in the form of a fully taxable transaction (i.e., one in which the full amount of the gain or loss inherent in the activity is recognized). According to Jacob, the liquidation was fully taxable because the only property distributed in liquidation was money, and he incurred a loss on the disposition of his interest. The IRS countered that Jacob wasn't entitled to claim the suspended passive activity losses because he didn't establish that he disposed of his entire interest in a fully taxable transaction to an unrelated party.

The Tax Court agreed with the IRS and held that Jacob failed to carry his burden of showing that Code Section 469(g)(1) permitted him to treat the passive losses as ordinary losses. The court noted that the linchpin of Jacob's argument was that he bought the partnership's racing and breeding horses before the liquidation for their book values. But the court said that Jacob failed to show a sale occurred because no money changed hands when he allegedly bought the horses or when the partnership distributed the proceeds in liquidation of the partnership.

For a discussion of when passive losses can be treated as non-passive, see *Kleinrock's Analysis and Explanation*, Section 50.16.

IRS Certifies Ford Escape and the Mercury Mariner Hybrids for Clean-Fuel Vehicle Deduction

The IRS has certified the model year 2006 Ford Escape Hybrid and the 2006 Mercury Mariner Hybrid vehicles as being eligible for the clean-burning fuel deduction. This certification means that taxpayers who purchase one of these hybrid vehicles new during calendar year 2005 may claim a tax deduction of up to \$2,000 on Form 1040.

IR-2005-132 (11/7/05).

Code Section 2703**Buy-Sell Agreement Disregarded in Determining FMV of Decedent's Shares**

A modified buy-sell agreement was properly disregarded for purposes of determining the value of a decedent's shares in a corporation for estate tax purposes. *Estate of Blount v. Commissioner*, No. 04-15013 (11th Cir. 10/31/05).

Blount Construction Company (BCC) was a construction company that had only two shareholders, William Blount and James Jennings. In 1981, the company and the shareholders entered into a stock purchase agreement. This agreement required shareholder consent to transfer BCC stock and provided that BCC would purchase the stock at the death of the holder at a price agreed on by the parties, or, in the event there was no agreement, for a purchase price based on the book value of the corporation. In connection with an employee stock exchange program, BCC was valued by a third party as being worth roughly \$7.9 million in January 1995. BCC owned insurance policies which would provide roughly \$3 million each for the repurchasing of William and James's stock. When James died in 1996, BCC received about \$3 million from the insurance proceeds, and paid a little less than \$3 million to his estate.

After being diagnosed with cancer, William executed a November 1996 amendment that required BCC to pay his estate \$4 million in exchange for his BCC shares owned at his death. When William died in the following year, he owned roughly 83 percent of BCC and the company paid the amount to his estate. The company reported the \$4 million as the value of the shares and the IRS issued a deficiency notice asserting that William's stock was worth \$7.9 million, which meant that the fair market value of BCC exceeded \$9.5 million at the date of his death. The Tax Court held that the 1981 agreement, as modified by the 1996 agreement, was to be disregarded for purposes of determining the value of the shares.

The Eleventh Circuit held that the 1981 buy-sell agreement as modified by the 1996 amendment was properly disregarded for purposes of valuing William's shares in BCC for estate tax purposes. Generally, the court stated, the value of the taxable estate is the fair market value of the decedent's property at the time of death. There is an exception for valid buy-sell agreements to the general rule that stock must be valued at its fair market value. This exception requires, among other things, that the agreement must be binding on the parties both during life and after death.

The Eleventh Circuit observed that, by the time the 1996 agreement was consummated, the only remaining parties were BCC and William. William owned an 83 percent interest in BCC and was the only person on BCC's board of directors, and was the company president. William had the unilateral ability to modify the 1981 agreement and he did

so with the 1996 amendment. As such, the court said, the 1981 agreement was not a restrictive agreement that was binding during life and the value of the shares in his estate must be determined by using a fair market valuation.

For a discussion of fair market valuations in general, see *Kleinrock's Analysis and Explanation*, Section 780.2.

Code Section 6011**IRS Provides Requirements For Obtaining E-File Waivers**

New procedures are available for corporations, electing small business corporations, and tax-exempt organizations to request a waiver of the requirement to electronically file certain returns. Notice 2005-88, 2005-48 __; IR-2005-133 (11/10/05).

In early 2005, the IRS issued temporary regulations that require certain large corporations, electing small business corporations, and certain exempt organizations, beginning in 2006, to electronically file their income tax or annual information returns. The regulations permit the IRS to waive the electronic filing requirement if the taxpayer demonstrates that undue hardship would result if it were required to file its return electronically.

The IRS has now issued guidance on steps corporations, electing small business corporations, and tax-exempt organizations can take to request a waiver of the requirement to electronically file certain returns. Under Notice 2005-88, taxpayers can request waivers from the electronic filing requirement in situations: (1) where the taxpayer cannot meet electronic filing requirements due to technology constraints; or (2) where compliance with the requirements would result in undue financial burden on the taxpayer.

To request a waiver, the taxpayer must file a written request containing the following information: (1) a notation at the top of the request stating, in large letters, "Form 1120 e-File Waiver Request," "Form 1120S e-File Waiver Request," "Form 990 e-File Waiver Request," or "Form 990-PF e-File Waiver Request;" (2) the taxpayer's name, tax identification number, and mailing address; (3) the type of form for which the waiver is requested; (4) the taxable year for which the waiver is requested; (5) the value of the taxpayer's total assets at the end of the taxable year as reported (or to be reported) on the entity's Forms 1120, 1120S, 990, or 990-PF; (6) a detailed statement listing the steps the taxpayer has taken in an attempt to meet its obligation to timely file its return electronically, why the steps were unsuccessful, and an explanation of the undue hardship that would result from compliance; (7) a statement as to what steps the taxpayer will take to ensure that it will be able to file future returns electronically; and (8) a statement signed by an officer authorized to sign the return containing specific language providing for a declaration on penalties of perjury.

The Notice also provides guidance for the timely filing of rejected e-file returns.

For a discussion of electronic filing of tax returns, see *Kleinrock's Analysis and Explanation*, Section 605.5.

Code Section 6015

Tax Court Allocates Part of Joint Deficiency to Innocent Spouse

An innocent spouse was liable for a portion of a deficiency and an accuracy-related penalty arising from a joint return, as calculated by the Tax Court. *Estate of Capehart v. Commissioner*, 125 T.C. No. 10 (11/14/05).

Robert and Ingrid Capehart filed a joint return for 1994. The return included losses from an investment in a cattle partnership that was a tax avoidance scheme, theft losses, and deductions for medical and dental expenses. The IRS disallowed the claimed losses equally to Robert and Ingrid. Erroneous items amounting to \$42,565 were added back to the couple's income. The IRS agreed that Ingrid was entitled to innocent spouse relief but disagreed with her as to the portion of the joint deficiency and related accuracy penalty that was allocable to her.

Generally the portion of the deficiency on a joint return allocated to an individual eligible for innocent spouse treatment is the amount that bears the same ratio to the deficiency as the net amount of items taken into account in computing the deficiency and allocable to the individual under Code Section 6015(d)(3) bears to the net amount of all items taken into account in computing the deficiency. Under Code Section 6015(d)(3)(A), items giving rise to a deficiency on a joint return (erroneous items) are allocated to each spouse as though each had filed a separate return for the taxable year. The requesting spouse is liable only for his/her proportionate share of the deficiency. However, there is an exception to this rule in Code Section 6015(d)(3)(B), which provides that an item giving rise to a deficiency that is attributable to one spouse must be allocated to the other spouse to the extent the item gave rise to a tax benefit on the joint return to the other spouse.

The Tax Court computed Ingrid's tax due by looking at a schedule showing how the couple's income and expenses would have been divided if separate returns had been filed for 1994. The schedule showed that Ingrid would have had taxable income of \$14,204, while her husband would have had taxable income of \$37,967. The court first allocated Ingrid's share of the erroneous items (\$21,282) to her to the extent of the \$14,204 separate taxable income. The \$7,078 excess, the court said, is allocated to Robert. The court then multiplied the deficiency times a fraction, the numerator being the net amount of the erroneous items allocated to Ingrid but limited by Ingrid's separate taxable income and the denominator being the net amount of all erroneous items.

The court rejected Ingrid's assertion that her share of the deficiency should be limited to the tax she would have paid on taxable income of \$14,204 had she filed a separate return, noting that neither the statute nor the regulations provide for such a limitation.

Finally the court held that the alternative allocation method set forth in Reg. Section 1.6015-3(d)(6)(i) does not apply because erroneous deductions are not erroneous items that are subject to tax at different rates as required by that provision.

For a discussion of innocent spouse relief and separation of liability, see *Kleinrock's Analysis and Explanation*, Section 605.5

TAX PLANNING, from p. 1

Where a client expects to be in a significantly higher tax bracket or have less deductions in the following year, practitioners may want to recommend that the client either accelerate income into the current year or shift deductions into the following year. On the other hand, if the client expects to be in a lower tax bracket in the future, practitioners may want to recommend postponing the realization of income into the following year or accelerating deductions into the current year.

This article provides a checklist of options practitioners should consider in advising clients on their year-end tax planning. It also reviews important new items practitioners should be aware of when preparing 2005 returns and in discussing the 2006 tax year with clients.

✓ **OBSERVATION:** As *Kleinrock's Federal Tax Bulletin* went to press, Congress was considering a tax reconciliation bill which, if enacted, would affect various provisions discussed below. If Congress passes the bill, a summary of the tax provisions will be immediately available on www.kleinrock.com.

Year-End Tax Planning

Accelerating Income

1. For clients over 59½ who are covered by an employer's retirement plan or an IRA, practitioners should recommend taking additional distributions in 2005.

2. Clients planning asset sales in the near future to raise cash should consider selling their most appreciated assets before the end of 2005.

3. For clients involved in a lawsuit or any kind of litigation seeking damages, consider settling by the end of the year, if possible.

4. For clients that have sold assets on the installment basis, consider accelerating payments from the buyer, if possible, or negotiating with a third party to purchase the installment obligation. Another way to accelerate income from an installment note is to use the note as collateral on a loan.

5. Self-employed individuals should try to collect as many accounts receivable as possible before the end of the year. Alternatively, where services will be provided next year, try to get customers to prepay for the goods or services. Consider offering incentives for early payment.

6. If it makes good business sense, have clients with incentive stock options exercise those options before the end of 2005.

7. Where a client receives restricted stock from an employer, consider making a Code Section 83(b) election to recognize the income before the interest in the stock vests. Remember that the election must be made within 30 days of receiving the restricted stock to be effective.

Deferring Income

1. If possible, employees should arrange for their employers to defer any bonus payments until early 2006.

2. Employees should max out their 401(k) contributions.

3. Self-employed individuals should delay year-end billings so payments do not come until the following year.

4. If a client is in financial difficulty and working with creditors on discharging obligations, try to postpone finalizing any debt cancellation that will result in cancellation-of-debt income until next year.

Accelerating Deductions

1. Consider accelerating any large purchases into 2005 to take advantage of the state sales tax deduction which ends in 2005. For a taxpayer in a state that has an

income tax, this strategy only works where the total sales tax will be more than the taxpayer's state income tax.

2. If the taxpayer is considering donating a vehicle to a charity, find a charity that will use the car and not sell it so that the taxpayer can take a fair market value deduction and not be limited to the gross proceeds from the sale of the vehicle. See discussion of car donations below under "New for 2005."

3. Prepay any January mortgage payment. However, practitioners should also double check the number of payments made in the current year. It is possible that the January 2005 payment was made in 2004 and will not be reflected on documentation from the mortgagor.

4. Prepay deductible expenses in 2005 instead of deferring payment until 2006. Consider using credit cards to make purchases or contributions so that the cash outlay may be postponed until 2006.

5. Prepay state and local taxes that are anticipated to be due for the 2005 tax year. Note that the prepayment must be reasonable. Also, state income taxes are not deductible for the alternative minimum tax, so practitioners must determine in advance whether this strategy will be useful to a client.

6. Pay any contested deductible taxes in 2005.

7. Where possible, have the client establish a Keogh retirement plan before the end of the year. While post-year-end contributions may be deductible in 2005, the plan must be in place before year's end for the client to get the deduction.

8. Consider an IRA contribution. The contribution is deductible at any time up to the tax return deadline.

Take Advantage of Recent Tax Law Changes with Kleinrock's 2005 Federal Tax Update!

Kleinrock's 2005 Federal Tax Update has everything you need to take advantage of the many legislative and regulatory changes affecting your practice this year, including:

- The new Energy Bill
- Katrina Relief Act
- Transportation Act changes
- Bankruptcy reforms

As well as all the section 199 proposed regulations

Be ready when tax season hits — get everything you need to help both you and your clients this year with Kleinrock's 2005 Federal Tax Update. Call 800-944-8883 now to order for just \$50. Don't forget to mention your special code: ATX05202.

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9. Because medical and dental expenses are deductible only to the extent they exceed 7.5 percent of the taxpayer's adjusted gross income, where possible, a client should bunch these expenses into one year to get a deduction. Thus, clients should schedule any elective dental or medical work this year and pay for such services before the end of 2005.

10. Consider selling investment assets on which losses have accumulated. Up to \$3,000 of capital loss is available in the current year.

Deferring Deductions

1. If the client has receivables outstanding and there is a question as to whether they will ever be collectible, consider leaving the door open as to whether collection is possible by not exhausting all remedies to collect on the receivable. Thus, a bad debt deduction will be deferred into a future period.

2. Postpone paying deductible business expenses until 2006.

3. Postpone selling investments that will generate capital losses.

New for 2005

Qualified Production Activities Income Deduction

The Code Section 199 qualified production activities deduction went into effect in 2005 and can benefit many businesses. It provides a 3 percent deduction for the lesser of: (1) a taxpayer's qualified production activities income for the tax year, or (2) taxable income (or, for an individual, adjusted gross income), determined without regard to Code Section 199, for the tax year.¹

For a detailed discussion of this deduction, see *Kleinrock's Federal Tax Bulletin*, Volume 8, Issue 23 (Nov. 7, 2003).

Six-Month Automatic Extensions Available for 2005 Tax Returns

The IRS has streamlined the process for extending the due date of individual, small business, and partnership returns. Automatic six-month extensions are now available. See the article on the bottom of page 1 for more details.

Telefile Discontinued

The IRS discontinued its telefile program as of August 17, 2005. The program allowed taxpayers to file Forms 1040EZ, 4868, and 941 by telephone.²

IRA Deduction Expanded

The IRA deduction increased from \$3,000 in 2004 to \$4,000 (\$4,500 if age 50 or older at the end of 2005) in 2005. A taxpayer may be able to take an IRA deduction if the taxpayer was covered by a retirement plan and

the taxpayer's modified adjusted gross income (AGI) is less than \$60,000 (\$80,000 if married filing jointly or qualifying widow(er)).³

Elective Salary Deferrals Increased

The amount a taxpayer can defer under all elective salary deferral plans increased in 2005 to \$14,000 (\$10,000 if the taxpayer only has SIMPLE plans; \$17,000 for Code Section 403(b) plans if the taxpayer qualifies for the 15-year rule). The catch-up contribution limit for taxpayers 50 or older increased to \$4,000 (\$2,000 for SIMPLE plans).⁴

Car Donations

Beginning in 2005, the rules for car donations changed, making such donations less attractive. Previously, taxpayers could deduct the fair market value of cars donated to a charity. However, if the charity sells the car, a taxpayer's deduction is equal to the proceeds received by the charity. If the charity does not sell the car and instead uses the car in furthering its charitable purpose, the taxpayer may be entitled to deduct the vehicle's fair market value if certain conditions are met.⁵

Standard Mileage Rates Increased

The 2005 standard mileage rate for business use of a vehicle is 40.5 cents for January through August. Beginning in September, that rate increases to 48.5 cents. The 2005 rate for using a vehicle to get medical care or to move is 15 cents a mile for January through August, and 22 cents a mile thereafter.⁶

New Definition of Qualifying Child

A uniform definition of "qualifying child" took effect in 2005. The new definition was enacted as part of a uniform definition of "child" that applies for purposes of the dependency exemption, the child tax credit, the earned income credit, the dependent care credit, and head of household filing status.

New Rules for Foster Child

New rules apply to determine who is a foster child and when a foster child can be used to claim certain tax benefits. To claim a foster child as a qualifying child for purposes of taking a dependency exemption, claiming the child tax credit, filing as head of household, taking the credit for child and dependent care expenses, or taking the earned income credit, the child must be placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction. A foster child no longer qualifies the taxpayer to use qualifying widow(er) filing status.

Dependents Can't Claim Exemptions for Dependents

New for 2005, if an individual can be claimed as a dependent on someone else's return, that individual cannot claim any exemptions for dependents.

Katrina Emergency Tax Relief Act of 2005

The Katrina Emergency Tax Relief Act of 2005 (the Act) provides a variety of tax incentives for those affected by the hurricane and those helping those affected.

Charitable donations

As a result of the Katrina Emergency Tax Relief Act, limitations on certain charitable contributions are eliminated thus allowing individuals to substantially reduce their 2005 taxable income.

Under the Act, taxpayers can elect to have the 50 percent income limitation rule not apply to cash contributions starting on August 28, 2005, through December 31, 2005, to charitable organizations (other than private foundations). If this election is made, these contributions are deductible to the extent that the aggregate of the contributions does not exceed the excess of the taxpayer's contribution base over the amount of all other charitable contributions allowed after applying the 50 percent limitation. In addition, the taxpayer's charitable deduction up to the amount of contributions qualifying under this provision is not subject to the overall limitation on itemized deductions.⁷

✓ **OBSERVATION:** Although this provision was enacted in connection with Hurricane Katrina relief, these contributions do not have to be related to Hurricane Katrina. Non-Katrina-related charities have reported significant reductions in donations in the wake of the hurricane. This provision provides an incentive for donors to make additional donations to compensate for the drop-off in revenue these organizations have felt as charitable giving has been diverted to hurricane relief.

Since this provision expires at the end of 2005, taxpayers should consider accelerating any planned giving into 2005, if possible.

For corporations, the 10 percent income limitation for cash donations is waived for cash contributions to charitable relief efforts related to Hurricane Katrina made before 2006. In addition, these contributions are not considered in applying the charitable donation carryover rules to other contributions.

Finally, the Act also increases the standard mileage rate for the charitable use of personal vehicles. Generally, individuals may claim a 14 cents-per-mile tax deduction for the costs of using a personal vehicle for charitable work. The Act increases the standard mileage rate for individuals providing Hurricane Katrina relief to 29 cents per mile from August 25, 2005, through August 31, 2005, and 34 cents per mile for the rest of 2005.

Retirement plans

The Katrina Emergency Tax Relief Act of 2005 also contains special provisions relating to "qualified Hurricane Katrina distributions."

For those affected by Hurricane Katrina, the Act waives the 10 percent tax on early distributions from

IRAs and pensions. The Act allows eligible individuals to withdraw a maximum of \$100,000 from their IRAs and pensions without incurring the 10 percent penalty tax.

Although the distributions are not subject to the penalty tax, the distributions are still subject to income tax. But the Act allows an individual receiving a qualified Hurricane Katrina distribution to pay the income tax on the distribution over a three-year period and no tax is due if the distribution is repaid within the three-year period. The Act also increases the limit on loans from pension plans from \$50,000 to \$100,000.

A qualified Hurricane Katrina distribution is any distribution from an eligible retirement plan made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss because of Hurricane Katrina.

The Act also allows a distribution received from a 401(k) plan, 403(b) annuity, or IRA to buy a home in the Hurricane Katrina disaster area to be re-contributed to the plan, annuity, or IRA in certain circumstances. The provision applies to a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA that: (1) is received after February 28, 2005, and before August 29, 2005; and (2) is to be used to buy or build a principal residence in the Hurricane Katrina disaster area, but the residence is not purchased or constructed because of Hurricane Katrina.

Under the provision, any portion of a qualified distribution may, from August 25, 2005, through February 28, 2006, be re-contributed to a plan, annuity, or IRA to which a rollover is permitted. Any amount re-contributed is treated as a rollover. Thus, that portion of the qualified distribution is not includible in income (and also is not subject to the 10 percent early withdrawal penalty).

Employer and employee tax relief

The Act also creates a new target group, called Hurricane Katrina employees, for purposes of the work opportunity credit and extends the work opportunity tax credit for that group of employees beyond the cut-off date of December 31, 2005. The target group is made up of individuals who, before Hurricane Katrina, resided in portions of the disaster area that are now eligible for federal assistance.

Employers located in such an area may claim the credit for Hurricane Katrina employees hired over the next two years. Employers located outside the Hurricane Katrina disaster area may claim the credit for Hurricane Katrina employees hired through the end of 2005.

The Act also provides an employee retention tax credit. Small employers located in a disaster area that is eligible for assistance may claim a tax credit through the end of the 2005 calendar year if they retain an eligible employee on their payroll. The tax credit equals 40

percent of the first \$6,000 of wages paid to the employee between August 28, 2005, and January 1, 2006. The credit is available to employers with an average of 200 or fewer employees in the tax year, whose business is inoperable because of Hurricane Katrina damage. The credit is not affected if the employee reports to work at another location while the business is inoperable.

Deduction for housing assistance

The Act provides a \$500 exemption deduction for individuals who provide rent-free housing in their principal residences for at least 60 days to dislocated persons. The deduction is \$500 per person housed, with a maximum of \$2,000. The deduction can be claimed in either 2005 or 2006, but cannot be claimed in both years for same person.

Additional relief provided by the Act includes:

- (1) the exclusion from income for certain forgiveness of debt;
- (2) a full deduction for personal casualty losses (i.e., elimination of the \$100 and 10 percent floors); and
- (3) increased time to replace property involuntarily converted.

Qualified Leasehold and Restaurant Improvement Depreciation Changes

Qualified leasehold and improvement property and qualified restaurant property placed in 2005 may be depreciated over 15 years. However, such property placed in service after 2005, must be depreciated over 39 years.⁸

Estate Provisions

For decedents dying after 2004, a deduction is allowed to the estate for any death taxes, (e.g., any estate, inheritance, legacy, or succession taxes) paid to any state or the District of Columbia, on property included in the gross estate of the decedent. For earlier years, these taxes were usually creditable against the federal estate tax (up to a limit).

New for 2006

State and Local Sales Taxes No Longer Deductible

Unless extended, the option for individuals to deduct state and local sales taxes instead of state income taxes is no longer available after 2005.⁹

Qualified Electric Vehicle Credit Reduced

The maximum qualified electric vehicle credit that a taxpayer may claim is reduced to \$1,000 in 2006.¹⁰ Previously, a \$4,000 credit had been allowed.

Increased Catch-up Contribution

For 2006, the maximum IRA contribution stays at \$4,000 but the over-50 catch-up contribution increases from \$500 to \$1,000. The SIMPLE plan catch-up amount

for taxpayers age 50 or over by the end of the tax year, subject to certain limitations, increases from \$2,000 in 2005 to \$2,500 in 2006.

Roth 401(k)s Available

Beginning in 2006, a 401(k) plan may include a qualified Roth contributions program. Under the Roth 401(k) option, a participant can elect to have all or a portion of the participant's elective deferrals (called designated Roth contributions) included in income when earned. Designated Roth contributions are treated in a manner similar to those of a Roth IRA; qualified distributions of these contributions, and income on them, are not included in income.¹¹

Energy Tax Credits

Beginning in 2006, two new residential energy credits are available courtesy of the Energy Policy Act of 2005—the non-business energy property credit and the residential energy efficient property credit.¹² The credits are available for the following types of energy-efficient property:

- (1) exterior doors;
- (2) heat pumps;
- (3) water heaters;
- (4) central air conditioners;
- (5) furnace or hot water boilers;
- (6) fans used in natural gas, propane, or oil furnaces;
- (7) insulation material or an insulation system specifically and primarily designed to reduce the heat gain of a dwelling unit;
- (8) exterior windows (including skylights);
- (9) qualified property for producing solar electricity;
- (10) qualified solar water heating property; and
- (11) qualified fuel cell property.

Condominium and cooperative owners also may be able to take advantage of the credit on a pro rata basis for repairs made by a condominium association or cooperative corporation.

Itemized Deduction Limitation Phase-Out

“High-income” taxpayers, may be able to take a larger amount of itemized deductions in 2006. That is because the reduction in itemized deductions for high-income taxpayers starts to phase out beginning next year.¹³ For years before 2010, an individual whose adjusted gross income (AGI) exceeds a prescribed amount must reduce his or her itemized deductions by an amount that depends on AGI. For years before 2006, the amount of the reduction is the lesser of 3 percent of the excess of AGI over the applicable amount or 80 percent of itemized

deductions. For 2006 and 2007, the amount of the reduction is two thirds of this amount. The following itemized deductions are not subject to this rule: (1) the deduction for medical expenses; (2) the deduction for investment interest; (3) the deduction for casualty losses; (4) the deduction for gambling losses; and (5) the deduction for charitable contributions in cash under Code Section 170 on or after August 28, 2005, and on or before December 31, 2005. (see above). These exceptions are meaningful only in calculating the 80 percent limit. They have no effect on the determination of 3 percent of AGI over the applicable amount.

Percentage Depletion Limitations Return for Marginal Producers

Generally, oil and gas producers are subject to an overall limitation on their depletion allowance of 100 percent of their net income from oil and gas production. For tax years beginning after December 31, 1997, and before January 1, 2006, there is no 100 percent taxable income limitation on "marginal producers" of oil and gas properties. During this time, percentage depletion has not been limited to the taxable income from the property for these producers. However, for tax years beginning after December 31, 2006, percentage depletion for marginal producers is again limited to net income from oil and gas production.¹⁴

Excluded Combat Pay Not Included for Earned Income Credit Purposes In 2006

Beginning in 2006, a taxpayer can no longer elect to include combat pay that is otherwise excluded from gross income in earned income in computing the earned income credit.¹⁵

AMT Exemption and Phase-Out Amounts for Individuals Reduced In 2006

The alternative minimum tax exemption amounts are reduced in 2006 from \$40,250 to \$33,750 for single/head of household and from \$58,000 to \$45,000 for married filing jointly/surviving spouses. The exemption amount for married filing separately is reduced from \$29,000 to \$22,500 in 2006. The exemption amount for estates and trusts and corporations remains \$22,500 and \$40,000 respectively for both years.

The 2005 AMT phase-out amounts (amounts at which the AMT exemption is completely phased out) are for single/head of household \$273,500, for married filing jointly/surviving spouse \$382,000, and for married filing separately \$191,000. These amounts are reduced in 2006 to \$247,500 for single/head of household, \$330,000 for married filing jointly/surviving spouse, and \$165,000 for married filing separately. The phase-out amount for trusts and estates is \$165,000 and \$310,000, respectively, for both years.¹⁶

✓ **PRACTICE TIP:** The reductions create a greater likelihood that a taxpayer's deductions will result in the taxpayer being subject to the AMT. Thus, taxpayers

should consider the effects of accelerating deductions into 2005. Given the tax incentives for 2005 charitable contributions in 2005, this is another reason that taxpayers should consider accelerating planned charitable giving into 2005.

Tax Credits and AMT

Generally, non-refundable tax credits can no longer be used to offset alternative minimum tax liability for tax years after 2005. However, the child tax credit, the adoption expenses credit, and, until its termination for years after 2006, the credit for retirement contributions by certain low-income individuals continue to offset AMT liability, even though these three credits are non-refundable.¹⁷

Other Tax Incentives No Longer Available

Unless extended, the work opportunity credit and the research activities tax credit expire at the end of 2005.

With respect to deductions, the deduction for qualified higher education tuition and related expenses is scheduled to terminate for tax years beginning after 2005. Also next year, unless extended, educators will no longer be able to deduct up to \$250 of certain classroom material in computing adjusted gross income.¹⁸

Reduction in Estate and Gift Tax Rate

The maximum tax rate for estates and gifts drops slightly next year, from 47 percent in 2005, to 46 percent in 2006. The amount of an estate that is excluded from the federal estate tax increases from \$1,500,000 in 2005 to \$2,000,000 in 2006. The gift tax exclusion amount remains \$1,000,000 for both years.¹⁹

Notes

1/ Code Section 199.

2/ Announcement 2005-26, 2005-17 I.R.B. 969.

3/ Code Section 219(b)(5)(A).

4/ Code Section 408(p)(2).

5/ Code Section 170(f)(12).

6/ Rev. Proc. 2004-64, 2004-2 C.B. 898; Announcement 2005-71, 2005-41 I.R.B. 714.

7/ Pub. L. 109-73, Katrina Emergency Tax Relief Act of 2005, Section 301. See also, Code Section 68.

8/ Code Section 168(e)(3)(v).

9/ Code Section 164(b)(5)(I).

10/ Code Section 30(b).

11/ Code Section 402A.

12/ Pub. L. 109-58, Energy Policy Act of 2005.

13/ Code Section 68(f).

14/ Code Section 613A(c)(6).

15/ Code Section 32(c)(2)(B)(vi).

16/ Code Section 55(d).

17/ Code Section 26(a)(2).

18/ Code Sections 62(a)(2)(D), 222(a).

19/ Code Sections 2001(c)(2)(B), 2010(c).

IN BRIEF

Capital Gains and Losses

Prebola v. Commissioner, T.C. Memo. 2005-261 (11/8/05): The Tax Court held that lump sum proceeds received by a taxpayer for the sale of her rights to lottery proceeds are ordinary income and not capital gain. *Code Section 1221.*

Credits

T.D. 9228, 70 Fed. Reg. 67,355 (11/7/05): The IRS issued final regulations on the low-income housing credit allocation and certification that are intended to reduce the filing burden for taxpayers through the elimination of the 15-year filing requirement. *Code Section 42.*

Employment Taxes

Hudack v. Commissioner, T.C. Summary 2005-159 (11/2/05): The Tax Court held that a taxpayer who was a full-time insurance salesman was a common law employee, rather than a statutory employee, and was not entitled to report gross income and expenses on Schedule C. *Code Section 3121.*

Exclusions from Gross Income

Andrew v. Commissioner, T.C. Summary 2005-158 (11/2/05): The

Tax Court held that social security benefits received on account of a taxpayer's physical disability are includible in gross income and the taxpayer was liable for the late filing penalty because uncertainty over the tax treatment of the social security benefits didn't constitute reasonable cause. *Code Section 86.*

Income Tax Withholding

Rev. Proc. 2005-71, 2005-47 I.R.B. __: The IRS announced that it was extending the sunset date of a voluntary compliance program available to certain withholding agents with respect to the withholding, payment, and reporting of certain taxes due on payments of foreign persons. *Code Section 1441.*

Procedure

Siddons v. Commissioner, T.C. Summary 2005-160 (11/3/05): The Tax Court held that the IRS abused its discretion in denying a taxpayer's claim for innocent spouse relief because she was not involved with her husband's business. *Code Section 6015.*

Market Discount/OID

Rev. Rul. 2005-75, 2005-49 I.R.B. __: The IRS released the 2006 inflation adjusted amount that a taxpayer may lend to a qualified continuing care facility without incurring imputed interest. For this purpose, the amount is \$163,300. *Code Section 7872.*

Rev. Rul. 2005-76, 2005-49 I.R.B. __: The IRS provided that the inflation adjusted amounts that set dollar ceilings on the stated principal amount of both qualified debt instruments and cash method debt instruments are \$4,630,000 and \$3,307,400, respectively. *Code Section 1274A.*

Miscellaneous

Notice 2005-82, 2005-47 I.R.B. __; Notice 2005-81, 2005-47 I.R.B. __: The IRS announced that it is postponing the deadlines for certain acts that it must perform with respect to taxpayers affected by Hurricanes Rita and Katrina. The Notice provides a postponement until February 28, 2006, for various acts by the IRS such as issuing a deficiency notice or assessing taxes. *Code Section 7508A.*

Code Section Index

Code Section 42

T.D. 9228..... 12

Code Section 72

Thomas v. Commissioner..... 3

Code Section 86

Andrew v. Commissioner..... 12

Code Section 170

Announcement 2005-84..... 3

Code Section 179A

IR-2005-132..... 4

Code Section 469

Ramsburg v. Commissioner..... 4

Code Section 1221

Prebola v. Commissioner..... 12

Code Section 1274A

Rev. Rul. 2005-76..... 12

Code Section 1441

Rev. Proc. 2005-71..... 12

Code Section 2703

Estate of Blount v. Commissioner..... 4

Code Section 3121

Hudack v. Commissioner..... 12

Code Section 6011

Notice 2005-88..... 5

IR-2005-133..... 5

Code Section 6015

Estate of Capehart v. Commissioner..... 6

Siddons v. Commissioner..... 12

Code Section 7508A

Notice 2005-82..... 12

Notice 2005-81..... 12

Code Section 7872

Rev. Rul. 2005-75..... 12