

A Top 10 list of 2008 developments for 2009 tax strategies

One technique for giving better focus to tax planning in a new year is to look back at the old one by looking at significant 2008 tax developments from the perspective of their impact on tax planning in 2009.

In examining 2008 developments a Top 10 list jumps out. This list gathers significant 2008 tax developments based on their impact on certain issues or themes. The list focuses only on those developments that have an impact on strategies that may be implemented in 2009 and that is the reason why a significant amount of tax legislation didn't make the list, but also the reason why some letter ruling and similar types of developments made the cut.

NO. 1: TAX SHELTERS

For the average taxpayer, the tax shelter developments of 2008 may seem a bit irrelevant, looking only like a battle of the titans between a few high-powered corporate lawyers and the Internal Revenue Service chief counsel and the head of the Justice Department's Tax Division. But aside from showing the general public that "fat cats" are being held accountable, legal precedent is being set that impacts on a broad spectrum of individual and business concerns.

Much of this activity, however, trickles down to make a meaningful difference to even relatively small-time tax strategies. Notable among this group are the ever-widening net cast by the government's use of the economic substance, step-transaction and work-product doctrines. It also has left a sizeable tax-shelters-facing bureaucracy within the IRS that, having disposed of many of the larger cases, is now on the prowl for other revenue opportunities. Recent investigations into "rollovers as business start-ups" (ROBs) and certain charitable remainder trusts confirm that outlook. In the process, too, an increasing number of legitimate shelters are

being subject to scrutiny and resulting legal fees, thus placing a chilling effect on tax strategies in general.

NO. 2: LOSSES

2008 was the first year in a long while when rules on net operating losses, capital losses and business/investment write-offs had to be dusted off. Unfortunately, most practitioners expect their use to increase in 2009.

Recently, the Treasury's unilateral lifting of the Internal Revenue Code of 1986, as amended Section 382 anti NOL trafficking regs for back mergers during the economic crisis has been hotly contested. On a lesser scale, but no less significant to many small investors, the IRS in 2008 proposed a more rigorous grouping of activities for purposes of determining application of the passive activity loss rules. Those regs should be watched carefully for 2009 planning.

Those individuals who are looking to make extra money in a side business during these economic hard times also should be warned that the IRS has begun to look more closely into aggressive planning within the hobby loss rules.

NO. 3 TAX-EXEMPT ORGS

In reaction to growing abuses within the operation of tax-exempt entities, from public charities down to private foundations, the IRS has stepped up its reporting requirements, as well as its auditing regime. A new and detailed Form 990 and instructions, due from exempt organizations, due from exempt organizations for the first time in 2009, aim to clamp down on charities that are being used in any way for private benefit.

Recently, the IRS warned against charities' "more aggressive tactics" in response to cutbacks in giving. The IRS also placed onto its hit list in 2008 the use of tax-exempt entities as "tax-neutral" parties in certain tax-shelter arrangements. Another anecdotal indication that care is

in order when crafting tax strategies in 2009 that involve a tax-exempt entity is the IRS TE/GE Division's general growth in personnel and authority over the past several years.

NO. 4: COMPENSATION

Final regulations on nonqualified deferred compensation, are set to go into force on Jan. 1, 2009, encroach on a surprising number of tax strategies. Code Sec. 409A applies to any promise to pay compensation in the future for services. As a result, compliance through plan amendment and adherence to reporting requirements must form an integral part of any compensation strategy.

Adding to related issues in 2008 that spill over into 2009 are the rigid compensation rules for tax-exempts as they are now applied to the detailed information required on the new Form 990; the compensation limits imposed on executives covered under the government's financial bailout package; and the current taxation of deferred compensation from tax-indifferent entities also added in the bailout package.

NO. 5: S CORPORATIONS

The S corporation, an evergreen tax-strategy workhorse, continues to evolve as the IRS issues guidance to address a variety of concerns. Among the areas of 2008 guidance that should be incorporated into 2009 S corporation strategies are proposed regulations on the S corp COD income exclusion, final Regs that limit use of open account debt to defer S corp income, and final regs that reflect statutory changes in handling family membership and QSubs.

NO. 6: LIKE-KIND EXCHANGE

Since like-kind exchange treatment is not optional for those transactions that qualify, 2009 may usher in more strategic use of steps that will "bust up" like-kind exchange treatment. Nevertheless, IRS guidance in 2008 showed that the agency appears ready to facilitate like-kind exchanges for those that want them. The more notable 2008 guidance allows use of the same

property for both forward and reverse exchanges; exchange of leased property in which build-to-suit clauses are allowed before ownership takes place; and the exemption of small escrowed facilitators from tax in deferred exchanges.

NO. 7: HOMEOWNERS

2008 tax developments create major changes for certain homeowners. Homeowners in mortgage workouts and foreclosures are generally now exempt from recognizing forgiveness-of-indebtedness income. Many first-time homebuyers can qualify for a tax-free, 15 year loan from the IRS of up to \$7,500.

On the tax-strategy side of the equation, however, a major loophole was closed. The Housing Assistance Act of 2008 now demands that the gain potentially eligible for the home sale exclusion (\$250,000 or \$500,000) be prorated between the time that a home is used as a principal residence and the total length of ownership, which includes any “non-qualifying” use as a rental or vacation property. Fortunately, non-qualifying use before the Jan. 1, 2009, effective date of the provision is not used in the calculation; neither are periods after a qualified use of the property or temporary absences of less than two years.

NO. 8: CORPORATE CHANGES

Tax strategist must be doing something right on the corporate level, as reported in 2008. According to a GAO report issued in 2008, the majority of corporations paid no income tax from 1989 to 2005. In addition, and no doubt related, the IRS also reported that foreign-controlled domestic corporations continue to grow.

More than 60,000 FCDCs had U.S. tax liability of \$42.2 billion for 2005, and increase of more than 40 percent from 2004. Speculation is that the increase will be even more dramatic through 2008 when those statistics are available.

IRS attention to the foreign side of corporate tax also grew, with regs targeting CFC non-recognition transactions, LMSB taking aim at foreign tax credit generator strategies, and regs attacking “Killer B” triangular reorganizations involving foreign corporations, providing a clear indication that the IRS want to be a participant in the debate over whether tax-avoidance techniques are the best way to even the playing field.

NO. 9: BACK-END PROBLEMS

Tax strategies continued to be hounded back-end problems in 2008, namely by way of the preparer penalty rules, an increasingly robust whistleblower program, and worry over the eventual enforceability of tax patents. While the tax preparer standard for undisclosed, non-abusive transactions was lowered from “more likely than not” to “substantial authority” by the recent Emergency Economic Stabilization Act, other tax preparer requirements now pending in proposed regs including a definition of preparers that will pull in many practitioners who devise tax strategies still present dangers.

Further, the IRS Whistleblower Office, relatively new at the start of 2008, reportedly is now doing a booming business, again not only calling outright fraudulent practices to the attention of the IRS, but also those tax strategies that may merely push the envelope. Lastly, the specter of being restricted from using certain tax minimization techniques because of patented strategies remains real, despite the Bilski victory in the Federal Circuit this past October on requiring a mechanical aspect to any patentable process.

NO. 10: THE OBAMA FACTOR

Perhaps the No. 1 2008 development is the election of Barack Obama as president. Major changes are apt to take place not only on the individual tax side, but also on the business side. Higher taxes for the more affluent are a given; tax relief for start-up businesses is also fairly

certain. Due to the economic crisis, the temporary postponement of any immediate tax increase is also possible.

The major issues of whether the corporate tax rate should be lowered in exchange for a broader base, and whether the U.S. tax system should change from a world-wide to a territorial tax system, also are likely to be addresses in 2009.

CONCLUSION

“What’s past is prologue” is clearly the case in anticipating what tax strategies will work in our changing tax world. As each month in 2009 passes, further adjustments to 2008-based forecasts will be necessary.