

TaxClinic

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The Tax Adviser would like to acknowledge the special contribution to the December Tax Clinic of Singer Lewak LLP; Mark G. Cook, tax partner in the Irvine, CA, office; and Steve Cupingood, the partner in charge of that firm's tax practice.

For additional information about these items, contact Mr. Koppel at (781) 407-0300 or mkoppel@gggcpas.com.

ACCOUNTING METHODS & PERIODS

Retailer Could Not Accelerate Rebate Liability via Recurring-Item Exception

On August 22, 2008, the IRS released Chief Counsel Advice (CCA) 200834019, addressing whether a retailer could use the recurring-item exception of Sec. 461(h)(3) to treat its cash rebate liability as incurred in the year of the sale of the rebate-eligible product.

In a nutshell, the Office of Chief Counsel concluded that the taxpayer may not do so, because the rebate liability was not fixed until the customer complied with the rebate requirements and thus did not meet the required all-events test. As a result, the question of the recurring-item exception's applicability was moot.

Incidentally, this CCA is apparently related to CCA 200826006, in which the IRS advised that a retailer's method of accounting for its cash rebate liabilities was not permitted under the regulations. In that case, the taxpayer did not record the full purchase price as income at the time of the sale, even though it received full price at that time. Instead, it reduced its gross receipts by the amount of its estimated rebate payment. Later, if a particular rebate expired, it reversed the prior reduction from gross receipts by bringing back into income the amount of its previously estimated rebate payment. The Service stated that this method did not follow Regs. Sec. 1.461-4(g)(3), which provides that economic performance for rebates occurs as payment is made to the person to whom the liability is owed.

Note: Various sources differ as to whether the economic performance rules are part of the all-events test. Even the IRS

seems to treat it both ways: In Publication 538, *Accounting Periods and Methods*, it seems to view economic performance as separate from the all-events test, whereas in CCA 200834019 it treats economic performance as a third prong in the all-events test. Practically speaking, there is no real difference, since Sec. 461(h)(1) provides that “the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.” Nevertheless, for purposes of this discussion, the all-events test will be treated as a two-prong test.

Background

An accrual-basis taxpayer is generally entitled to deduct an item in a particular year (assuming it is otherwise deductible in the first place) only to the extent that:

1. It meets the all-events test (i.e., all the events have occurred that establish the fact of the liability, and the amount of the liability can be determined with reasonable accuracy); and
2. Economic performance has occurred with respect to the liability.

In addition, Regs. Sec. 1.461-5(b)(1) provides a limited exception to the economic performance rules, allowing taxpayers who adopt it to accelerate the time at which economic performance is deemed met. This recurring-item exception allows a taxpayer to treat a liability as incurred for a tax year if:

1. At the end of the tax year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy;
2. Economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the tax year or (b) the fifteenth day of the ninth calendar month after the close of the tax year;
3. The liability is recurring in nature; and
4. Either the amount of the liability is not material, or accrual of the liability in the tax year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the tax year in which economic performance occurs.

Regs. Sec. 1.461-5(b)(5)(ii) provides that in the case of a liability for rebates, the

matching requirement of the recurring-item exception is deemed satisfied.

Note, however, that this exception to the usual economic performance rules does not override the all-events test and does not accelerate the deduction for items that are not fixed and determinable. Unfortunately, as in the case of the taxpayer in CCA 200834019, taxpayers often misunderstand this aspect of the recurring-item exception.

Details of CCA 200834019

The chief counsel advice addressed the case of a consumer products retailer using the accrual method of accounting. Like many retailers, the taxpayer had a cash rebate program that involved issuing cash payments to buyers that met specified conditions. Under the program, a third-party administrator handled the taxpayer’s rebate plan, processing rebate claims and issuing checks if the purchasers met all applicable conditions.

The conditions of the rebate were as follows: After purchasing the product, the buyer would have to:

1. Fill out the rebate form provided when the merchandise was purchased;
2. Cut out and attach a copy of the UPC code from the merchandise;
3. Attach a copy of the sales receipt; and
4. Send these items by mail to the third-party administrator within 30 days of the purchase date.

If the customer timely complied with the specified conditions, the third-party administrator would issue the customer a check in the amount of the rebate offer. The third-party administrator would wait to issue the check until at least 30 days had passed from the purchase date to ensure that the customer had not returned the merchandise, and the check was often issued several months after the rebate request was properly submitted. In addition, based on its experience, the taxpayer estimated that it only paid or redeemed a percentage of the total rebate offers.

Query from the field to the Office of Chief Counsel: The IRS field agent examining the taxpayer asked the Office of Chief Counsel for advice on whether all the events occurred that establish

the fact of the taxpayer’s liability for the cash rebates at the time of the issuance of the offers (at the time of the sale of a product), allowing it to treat the liability as incurred in the year of issuance, as long as the rebates were paid within the period permitted under the recurring-item exception.

Chief counsel’s opinion: The Office of Chief Counsel began its analysis by discussing the all-events and economic performance tests (which it collectively labeled the “all-events test”). It then moved into the issue of when the rebate liability became fixed, which was a prerequisite to the use of the recurring-item exception.

Citing several revenue rulings, as well as *General Dynamics Corp.*, 481 U.S. 239 (1987), and *Hughes Properties, Inc.*, 476 U.S. 593 (1986), the IRS pointed out that the rebate liability was not unconditionally due until the customer mailed a properly completed rebate form with attachments. It based its rationale on the premise that the taxpayer’s situation in the CCA was similar to that in *General Dynamics*, where the liabilities associated with the taxpayer’s self-insured medical plan were not fixed until the employee-patient submitted properly completed claim forms.

Moreover, the Service distinguished the taxpayer’s situation in the CCA from that of the Nevada casino operator in *Hughes Properties*, in which the taxpayer was required by state law to pay out a jackpot based on amounts gambled in progressive slot machines and was required to keep a cash reserve sufficient to pay the guaranteed jackpots when won. Because the amount of the casino’s liability was fixed by the slot machine payout indicators, the last event necessary to fix liability was the last play of the slot machine before the end of the casino’s tax year.

Conclusion

Ultimately, the IRS found the recurring-item exception question to be moot because the rebate liability was not fixed until the customer complied with the rebate requirements. Because the liability was not fixed, the taxpayer did not meet the all-events test with respect to that liability and was not entitled to a deduction for the estimated rebate liability at year end.

Even though the CCA may not be cited or used as precedent, it does persuasively rely on authoritative Supreme Court case law. CCA 200834019 demonstrates the importance of a careful analysis of the facts and circumstances associated with any potential deductions of year-end liabilities.

From Andrew Gantman, CPA, Singer Lewak LLP, Woodland Hills, CA (not affiliated with CPAmerica International)

CREDITS AGAINST TAX

IRS Issues Guidance on Energy Credit

The Energy Policy Act of 2005, P.L. 109-58, amended Sec. 48 to include qualified fuel cell property and qualified microturbine property on the list of property that can qualify for the energy credit. Pending the issuance of regulations, the IRS issued Notice 2008-68 to provide taxpayers with guidance on the computation and availability of the credits.

Although these technologies have been in development for years, the recent rise in oil prices and environmental concerns about “going green” have caused an increased focus on these types of alternative energy-generation technologies.

Qualified Fuel Cell Property

Sec. 48(c)(1) defines a qualified fuel cell property as a fuel cell power plant that satisfies the following conditions:

1. The plant must have a nameplate capacity of at least 0.5 kilowatt of electricity using an electrochemical process. Nameplate capacity is the maximum electrical output of a generator as rated by the manufacturer. Nameplate capacity is determined at the normal operating conditions designated by the manufacturer (Notice 2008-68, §3.01(7)).
2. The plant must have an electricity-only generation efficiency greater than 30%.

A fuel cell plant is an integrated system comprising a fuel cell stack assembly and an associated balance of plant components that convert a fuel into electricity using a chemical reaction rather than combustion (burning of a fuel) (Sec. 48(c)(1)(C)).

According to the U.S. Fuel Cell Council, an industry trade association, some of the advantages of fuel cell power plants over traditional grid power systems are:

1. They are a more reliable and consistent power source.
2. Power output is scalable because stationary fuel cell plants can be strung together as power needs change.
3. A fuel cell’s waste heat can be used in cogeneration.
4. Fuel cells are environmentally preferable. Some fuel cells may create only 20 grams of pollutants per megawatt hour (MWh) as compared with 11,000 grams per MWh for an average fossil fuel plant (U.S. Fuel Cell Council, www.usfcc.com/about/Fuel_Cells_for_Industrial_Applications.pdf).

Qualified Microturbine Property

Sec. 48(c)(2) defines a qualified microturbine property as a stationary microturbine power plant that satisfies the following conditions:

1. The plant has a nameplate capacity of less than 2,000 kilowatts. Nameplate capacity is determined at ISO conditions, which are 59° F, 60% relative humidity, and an atmospheric pressure of 14.696 pounds per square inch (Notice 2008-68, §§3.01(7), 6.04).
2. The plant has an electricity-only generation efficiency of not less than 26% under the same conditions.

A stationary microturbine power plant is an integrated system comprising a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and an associated balance of plant components that convert a fuel into electricity and thermal energy. A stationary microturbine power plant also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency, and power factors (Sec. 48(c)(2)(C)).

Some of the advantages of microturbine systems over reciprocating engine generators are a higher power-to-weight ratio, extremely low emissions, and fewer

moving parts (Kolanowski, *Guide to Microturbines* (Fairmont Press 2004)).

Qualification as Energy Property

Qualified fuel cell property and qualified microturbine property are creditable energy property only if certain matters related to qualification of the property for depreciation, original use by the taxpayer, and adherence to specific quality, performance, and electricity generation standards listed in Notice 2008-68, §3.02, are satisfied.

Computation of the Credit

The credit for fuel cell property and stationary microturbine power plants is claimed on Form 3468, Investment Credit. In general, the fuel cell credit is 30% of the basis of qualified fuel cell property placed in service during the tax year; for stationary microturbine power plants it is 10% of the basis of such property placed in service during the tax year.

However, the credit for any qualified fuel cell property shall not exceed an amount equal to \$500 for each 0.5 kilowatt of capacity of such property, and the credit for stationary microturbine power plants shall not exceed an amount equal to \$200 for each kilowatt of capacity of such property. In addition, certain adjustments to the credit may be required if the basis of the property qualifies for credit under other provisions of the Code. Likewise, adjustment to the credit may be required if the property is acquired using certain types of financing. The credit is available for qualified fuel cell property and stationary microturbine power plants for the period after December 31, 2005, and before January 1, 2017 (Secs. 48(a)(2)(A)(i)(II) and (c)(2)(D)).

Both credits are components of the Sec. 38 general business credit. Thus, when combined with all other components of the general business credit, for any tax year the credits generally may not exceed the excess of the taxpayer’s net income tax over the greater of (1) 25% of the net regular tax liability above \$25,000 or (2) the tentative minimum tax (Sec. 38(c)). For credits arising in tax years beginning after December 31, 1997, an unused general

business credit can be carried back one year and carried forward 20 years.

The Future

The city of Burbank, California, installed microturbines at its landfill site that are fueled by naturally occurring landfill gases. These gases were previously “flared” or burned off. The new system is capable of generating 550 kilowatts, enough energy to provide daily power to approximately 500 homes. The city hopes to be able to provide power to 20% of its residents through renewable sources by 2017 (City of Burbank Water and Power, www.burbankwaterandpower.com/news/landfill-gas-microturbine-generators/7-news/282-landfill-gas-microturbine-generators).

Today the major hurdle in converting to these technologies is cost. According to the Department of Energy, fuel cell technology in use today can cost \$4,500 per kilowatt as compared with current diesel generators, which can cost between \$800 and \$1,500 per kilowatt (Dept. of Energy, <http://fossil.energy.gov/programs/powersystems/fuelcells/>). Burbank’s landfill project was completed at a cost of approximately \$1.1 million. The Department of Energy hopes to significantly reduce the cost of these alternative energy sources by the end of the decade. Through additional research and development, tax credits, and other tax incentives, businesses should be able to economically migrate to these types of energy sources in the near future.

From Carl Sasaki, CPA, Singer Lewak LLP, Woodland Hills, CA (not affiliated with CPAmerica International)

EXEMPT ORGANIZATIONS

Changes to Form 990 Reflect IRS Policy Goals

The IRS recently issued major changes to Form 990, Return of Organization Exempt from Income Tax. This is the first major overhaul of Form 990 since 1979. The IRS focused on three primary areas in the redesign:

- Enhancing transparency;
- Promoting tax compliance; and
- Minimizing the burden on the filing organization.

The old Form 990 had only eight pages in the core form and included two schedules. The new form has 11 pages in the core form and 15 schedules. Not all organizations will have to file all the schedules. Based on IRS analysis, only 5% of nonprofit organizations will have to file more than 10 schedules.

Transitional Use of Form 990-EZ

For the 2008 filing tax year, some exempt organizations may choose to file form 990-EZ, Short Form Return of Organization Exempt from Income Tax, instead of the new Form 990 if their gross receipts are greater than \$25,000 and less than \$1 million and if they have total assets of less than \$2.5 million. In 2009, an organization with gross receipts greater than \$25,000 and less than \$500,000 and with total assets of less than \$1.25 million will qualify to file form 990-EZ. In 2010, an organization with gross receipts greater than \$50,000 and less than \$200,000 and with total assets less than \$500,000 will qualify to file that form. Organizations with gross receipts of \$25,000 or less must file Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ.

Goals of the New Form 990

The redesigned Form 990 addresses several complaints the IRS has received about the old Form 990:

- The questions and instructions were often unclear and very confusing. The best feature of the redesigned form is that the questions are less vague and offer more information about the organization’s activities.
- The arrangement of schedules was confusing and did not flow properly; the flow of the new form is more logical.
- The old form did not represent the organization’s activities during the year. Part III of the new form requires the organization to specify what it accomplished during the year; a blanket statement covering every year will not suffice.

Enhancing Transparency

The old form was missing some important items that reflect how the

organization used its assets. On the new form, it will be easier to follow how the organization used its assets to accomplish its exempt purpose. The new form will also compare some of the more important financial data from the prior year with the current year’s activities, which will make it much easier to see how the organization has done year to year.

The IRS wanted to make this form as easy as possible for the reader to understand. They wanted to standardize how every organization reports certain activities, such as the use of the organization’s assets, and also require more management accountability. Additional schedules will simplify the process of comparing similar organizations. There are many new schedules that will specifically address important parts of the core form, such as tax-exempt bond issues (Schedule K), hospital operations (Schedule H), and foreign activities (Schedule F).

The IRS spent a significant amount of time in this area. A potential donor can now compare similar organizations because there will be standard schedules that tax preparers must follow for various activities (e.g., fundraising and tax-exempt bonds). Because all similar organizations will have to report their current year’s activities in the same way, management will not be able to deceive the reader by attaching misleading schedules.

Minimizing the Burden on Filing Organizations

Although there are 15 new schedules, most organizations will not have to file them because many of the schedules will not apply. The IRS believes that less than 5% of tax-exempt organizations will have to file most of the new schedules. The most common compliments about the new form have been that the questions are now clear and the required schedules are easy to follow.

New Required and Suggested Policies

The new form focuses on a few new policies that the IRS believes public charities should implement if they have not already done so. The following written policies are required or suggested:

- *Conflict of interest for board members, officers, and senior staff:* Establish procedures to determine if a relationship, business affiliation, or financial interest results in a conflict of interest; what the board should do if such an event occurs; and how to mitigate potential excess benefit transactions. (A review of compensation agreements with interested parties is also recommended.)
- *Whistleblower policy:* Create procedures for the receipt, retention, and treatment of employee complaints regarding suspected financial impropriety or misuse of the organization's resources.
- *Document retention and destruction policy:* Establish guidelines on maintaining and documenting the storage and destruction of hard copy and electronic files.
- *Investment and joint venture policies:* Establish procedures to evaluate other entities (usually taxable) and preserve the organization's exempt status.
- *Easement policy:* Provide for the periodic inspection, monitoring, and enforcement of any conservation easements.
- *Gift acceptance policy:* Review any extraordinary contributions, require substantiation of gifts more than \$250, and adhere to state solicitation laws.
- *Compensation policy:* Outline procedures for payment, reimbursement, provision, and substantiation requirements before reimbursement of the following expenses:
 - First-class or charter travel;
 - Travel for companions;
 - Tax indemnification and gross-up payments;
 - Discretionary spending account;
 - Housing allowance or residence for personal use;
 - Payments for business use of personal residence;
 - Health or social club dues or initiation fees; and
 - Personal services.

Suggested Procedures

- Review the information return before filing with the IRS;

- Make sure that organizational documents are available to the public;
- Document board meetings;
- Review rules applied to lobbying and political activities by the organization; and
- Provide FIN 48 analysis on current and prior activities (this will also apply to audits of exempt organizations in the near future).

Suggested Committees

- An audit committee will have the responsibility for oversight of the audit and review or compilation of financial statements.
- A compensation committee is responsible for the documentation, review, and approval of compensation of officers and key employees of the organization.

Conclusion

The changes to the new form are dramatic and were necessary to enhance the transparency of organizations. They will also help make management more accountable for the day-to-day operation of the organizations. With the new core form and schedules it will be easier for readers to see exactly what the organization has done in the current year and to compare its operations from year to year to determine if they should contribute to such an organization.

From Lior Temkin, CPA, Singer Lewak LLP, Los Angeles, CA (not affiliated with CPAmerica International)

EXPENSES

Reminder: Support Your Auto Expense

Auto expenses are a very common deduction for business owners and employees who must travel. Often the taxpayer does not know the exact amounts necessary to calculate the proper deduction and the tax preparer must estimate the mileage, business percentage, and ultimate auto deduction with the client's help. Tax preparers should remind their clients to have proper substantiation or, if the IRS examines the return, the deduction will more than likely be denied.

If the substantiation is lost or stolen, the IRS will generally deny the deduction

because the *Cohan* rule (which allows a court to estimate deductible amounts of unsubstantiated expenses) cannot be applied for certain expenses, including automobile expenses (Sec. 274(d)(4)). In the case of a lost or stolen substantiation, combined with the nonavailability of contemporaneous records, substitute records may be provided, but they must include sufficient information to support the deduction (Temp. Regs. Sec. 1.274-5T(c)).

On September 24, 2008, the Tax Court, in a summary decision, upheld the Service's disallowance of an auto expense deduction of a traveling salesperson due to lack of substantiation (*Niyitegyeka*, T.C. Summ. 2008-129). It was obvious that the taxpayer traveled for business and would ordinarily be entitled to a deduction, but the submitted evidence was too weak to allow it.

Background

Sec. 6001 requires taxpayers to keep records to substantiate their tax liability. In the absence of such evidence, expenses can be estimated using circumstantial evidence per *Cohan*, 39 F.2d 540 (2d Cir. 1930). However, Sec. 274(d) overrides the *Cohan* rule and requires a taxpayer to substantiate auto expenses (along with a few others).

Temp. Regs. Sec. 1.274-5T(c)(2) expands upon the substantiation rule. The regulation states, "An account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure or use is made at or near the time of the expenditure or use." This means the record does not have to be documented at the exact same time as the expense, but it must be done within a reasonable time so that the time, place, amount, and business purpose can be recorded. The regulation gives the example that maintaining a log on a weekly basis is near enough to the expenditure to count as proper substantiation. The evidence may be written or recorded on an accessible computer memory device. The taxpayer may omit certain confidential information from the records as long as the information is available upon request.

Niyitegyeka

In *Niyitegyeka*, the taxpayer was a traveling salesperson in training. He would go to his employer's office in Manhattan and then drive to his customers' locations. The employer's policy was to not reimburse trainees for expenses related to this type of travel, including hotels, meals, and mileage. The taxpayer traveled often and went as far as Queens, New Jersey, and Connecticut. These facts were not in dispute.

Because the travel was definitely for business and the expenses were not reimbursable, a deduction for business mileage was proper. However, upon examination, the taxpayer did not present any evidence to substantiate the mileage. Thus, the Service disallowed the deduction. The taxpayer claimed that he kept his records in his car, which had been stolen. The taxpayer filed a police report and the car was later recovered, but the business records were gone.

The Tax Court gave the taxpayer the opportunity to present other evidence besides a contemporaneous log or receipts. Accordingly, the taxpayer presented a computer listing, purportedly from the employer, that detailed the dates, names, and amounts of his draw and commission activities.

According to the Tax Court judge who heard the case, this evidence was insufficient to justify granting the deduction, and the IRS's decision to deny the deduction was upheld. Specifically, the judge took issue with the following:

- This evidence was being presented for the first time at trial, as opposed to being available for the examiner.
- The listing was on plain white paper, which had no identifying marks, letterhead, or other indication of its source.
- No one from the employer was presented to corroborate the listing.
- There were no addresses, locations, or distances listed, so mileage could not be determined.
- Neither the tax preparer, the taxpayer's clients, nor anyone else was called by the taxpayer to testify on his behalf.

Accordingly, the court found that the listing was not sufficient evidence to support

the deduction that the taxpayer sought. The judge noted that no evidence presented in this case provided "a rational basis on which we may determine even a partial deduction."

Conclusion

In the *Niyitegyeka* case, because it was an undisputed fact that deductible travel did happen, it seems that had the taxpayer done a bit more work there might have been sufficient substantiation for the Tax Court to approve the deduction. Tax preparers can provide a great service by being sure their clients have proper documentation for automobile expenses in case of an audit. This may seem daunting to the client, so the tax preparer can be the client's friend by knowing how the client goes about his or her business and suggesting a method that is easy for the taxpayer to use. Does the client have an appointment book in which the business mileage for each appointment could be written down? If not, can the client use a wall calendar to document the business mileage?

Keeping track of expenses on a regular basis can be an annoying chore. However, the bottom line is that a simple process of documenting a few extra items, using tools the client already has, can save the client a big headache during an examination.

From Ali Allison, CPA, Singer Lewak LLP, Los Angeles, CA (not affiliated with CPAmerica International)

Temp. Regs. Allow Deemed Election to Expense Startup, Organizational Costs

Effective July 8, 2008, the IRS issued new temporary regulations to amend the rules under Secs. 195, 248, and 709 regarding elections to deduct startup expenditures and organizational expenditures of corporations and partnerships (T.D. 9411).

The major change in these new regulations is that they make the election to deduct startup costs and organizational expenditures *automatic*. Previously, a taxpayer had to attach a separate election to its return in order to elect to deduct startup expenses under Sec. 195(b) or organizational expenses under Secs. 248(b)

or 709(b). The temporary regulations eliminate this requirement for expenses paid or incurred after September 8, 2008 (Temp. Regs. Secs. 1.195-1T(b), 1.248-1T(c), and 1.709-1T(b)(2)).

The election either to amortize startup/organizational expenditures or to capitalize them is irrevocable and applies to all costs related to the active trade or business. A change in the characterization of an item as a startup/organizational expenditure is a change in accounting method to which Secs. 446 and 481(a) apply if a taxpayer has treated the item consistently for two or more tax years.

Background

As amended by §902 of the American Jobs Creation Act of 2004, P.L. 108-357, Secs. 195(b), 248(a), and 709(b) allow an electing taxpayer to deduct, in the tax year in which the taxpayer begins an active trade or business, an amount equal to the lesser of (1) the amount of the startup or organizational expenditure that related to the active trade or business, or (2) \$5,000, reduced (but not below zero) by the amount by which the startup expenditures exceed \$50,000. The remainder of the startup or organizational expenditures is amortized over a 180-month period (15 years) beginning with the month in which the active trade or business begins.

Under the prior regulations, the election to amortize startup and organizational expenses had to be made in an affirmative statement attached to a timely filed tax return (including extensions) (Regs. Secs. 1.195-1(b), 1.248-1(c), and 1.709-1(c)). Once made, this election was irrevocable, which created issues for taxpayers that improperly deducted startup or organizational expenses as ordinary business expenses. If it was later determined that an expense was a startup or organizational expense rather than an ordinary expense, the taxpayer would be unable to deduct or amortize them. However, if a taxpayer timely filed a return for the year without making the election, the taxpayer could still make the election by filing an amended return within six months of the return's due date (excluding extensions). The election had to be clearly indicated on the amended return, along

with the notation “Filed pursuant to Section 301.9100-2.”

Example: X, a calendar-year corporation, incurs \$36,000 of startup expenditures that relate to an active trade or business that begins on August 1, 2009. X is deemed to have elected to deduct startup expenditures under Sec. 195(b) in 2009. Therefore, X may deduct \$5,000 and the remaining portion of the amortizable amount of \$29,000 (\$36,000 – \$5,000) starting in 2009.

Definition of Startup Costs and Organizational Costs

As the name implies, startup costs are expenses incurred before the business actually begins, otherwise referred to as preopening expenses. Most startup expenditures can be segregated into two broad categories: (1) investigatory expenses and (2) business preopening costs. Organizational costs include all amounts paid to organize a corporation/partnership and the direct costs of creating the corporation/partnership.

According to Publication 535, *Business Expenses*, startup costs include amounts paid for the following: (1) An analysis or survey of potential markets, products, labor supply, transportation facilities, etc., (2) advertisements for the opening of the business, (3) salaries and wages for employees who are being trained and their instructors, (4) travel and other necessary costs for securing prospective distributors, suppliers, or customers, and (5) salaries and fees for executives and consultants or for similar professional services. Keep in mind that startup costs do not include deductible interest, taxes, or research and experimental costs.

Under Secs. 248(b)(3) and 709(b)(3), an organizational cost must be:

1. For the creation of the corporation/partnership;
2. Chargeable to a capital account;
3. Amortizable over the life of the entity if it has a fixed life; and
4. Incurred before the end of the first tax year in which the entity is in business.

According to Publication 535, examples of organizational expenses for corporations include the costs of temporary directors and organizational meetings, state incorporation fees, and the costs of legal services.

Examples for partnerships include legal and accounting fees for services incidental to the organization of a partnership and filing fees.

From Shashi Mirpuri, CPA, Tax Manager, Singer Lewak LLP, Granada Hills, CA (not affiliated with CPAmerica International)

GAINS & LOSSES

IRS Provides Guidance on Pre-Ownership Change Capital Contributions

Sec. 382 provides limitations on the amount of a pre-ownership change loss that a taxpayer can use to reduce post-change taxable income. Sec. 383 limits the use of pre-change credits and capital losses using the ownership change rules found in Sec. 382.

Generally, the Sec. 382 limitation is approximately equal to the loss corporation's fair market value multiplied by the applicable long-term tax-exempt rate (Sec. 382(b)(1)). This rate is approximately equal to the three-month average federal long-term tax-exempt bond rate (Sec. 382(f)). A provision found in Sec. 382(l)(1) provides that if a capital contribution is made within two years of the ownership change and is part of a plan, a principal purpose of which is to avoid or increase the Sec. 382 limitation, then the increase in the loss corporation's value is disregarded for purposes of the calculation of the Sec. 382 or 383 limitations.

The IRS intends to issue regulations regarding the application of this provision. Until they are issued, the rules set forth in Notice 2008-78 apply and can be relied on by taxpayers. The general rule outlined in the notice is that a capital contribution made in the two-year period before the ownership change will not be presumed to be a part of a plan the principal purpose of which is to avoid or increase the Sec. 382 and 383 limitations.

Just as with most IRS guidance, the Service does its best to provide assistance to taxpayers by first indicating that the determination as to whether the taxpayer made a capital contribution with the intent of increasing the Sec. 382 and 383 limitations is made based on an analysis of all the facts and circumstances surrounding the contribution. In addition,

the IRS provides some additional guidance in the form of four safe harbors that may be relied on where it might otherwise be unclear whether such a contribution was made as part of a plan to increase the Sec. 382 and 383 limitations.

The IRS will not consider a taxpayer's capital contribution as part of a plan to increase the limitations if one of the following four safe harbors is satisfied:

1. The contribution is not made by a controlling shareholder—determined just before the contribution—nor by a related party; no more than 20% of the value of the corporation's stock is issued in connection with the contribution; there was no agreement or substantial negotiation at the time of the contribution that would result in an ownership change; and the ownership change occurs more than six months after the contribution.
2. The contribution is made by a related party, but no more than 10% of the value of the loss corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party; in either case there was no agreement at the time of the contribution that would result in an ownership change; and the ownership change occurs more than one year after the contribution.
3. The contribution is made in exchange for stock issued in connection with the performance of services or stock acquired by a retirement plan.
4. The contribution is received on the formation of a loss corporation or is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes.

As mentioned, taxpayers may rely on this guidance for any ownership change occurring in a tax year that ends after September 25, 2008. The IRS expects to incorporate the guidance in the notice into the regulations when they are issued and is requesting comments on this guidance. In light of the market changes occurring and the prior lack of clarity on this matter, taxpayers should find this guidance useful.

From Mark G. Cook, CPA, MBA, Singer Lewak LLP, Irvine, CA (not affiliated with CPAmerica International)

GROSS INCOME

New Rules Seek to Reduce Tax Advantages of Converting Second Home to Principal Residence

On July 30, 2008, the 2008 Housing and Economic Recovery Act, P.L. 110-289, was signed into law by President Bush. While the act was principally aimed at strengthening the ailing housing market and injecting confidence into its related government-sponsored enterprises, it did contain some noteworthy tax provisions, which largely targeted homeowners, creditors, and state and local authorities.

Because the roughly \$16 billion tax arm of this housing relief package was intended to be revenue neutral, the act includes a few significant revenue offsets, one of which seeks to close, at a projected cost to taxpayers of \$1.4 billion over the next 10 years, a long-standing loophole previously available to homeowners with multiple residences.

Exclusion on Sale of Primary Residence

Under Sec. 121, a taxpayer can exclude up to \$250,000 (\$500,000 if married filing jointly) from gross income on the sale or exchange of his or her principal residence provided the taxpayer owned and occupied the property as his or her principal residence for an aggregate two-year period during the five-year period ending on the date of the sale or exchange. The exclusion is available for repeated use over a taxpayer's lifetime but typically, excluding certain exceptions such as a change in place of employment, health, or unforeseen circumstances, it cannot be used more than once every two years.

Before the passage of this most recent legislation, taxpayers who concurrently owned one or more residences and who, at some point in the future, intended to convert a home other than their existing primary residence into their primary residence had the opportunity to exclude \$250,000/\$500,000 of gain from income on the ultimate disposition of these residences, provided that the

ownership and use time requirements of Sec. 121(a) were satisfied. The maximum exclusion was available to these taxpayers despite the nature of the prior use of the second residence as a rental property, an investment property, a vacation property, or property used in a trade or business.

Periods of Nonqualified Use Will Trigger Gain Recognition

With the passage of the Housing and Economic Recovery Act, beginning January 1, 2009, the full \$250,000/\$500,000 exclusion under Sec. 121 will no longer be available on the sale of a taxpayer's principal residence if the residence was subject to nonqualifying use prior to its ultimate disposition (Sec. 121(b)(4)(A)).

Definition of nonqualifying use: For purposes of determining the amount of the Sec. 121 exclusion, a period of nonqualifying use is defined as "any period during which the property is not used as the principal residence of the taxpayer" (Sec. 121(b)(4)(C)). For example, periods of property use as a rental property, a vacation home, investment property, or property used in a trade or business would be periods of nonqualifying use.

Note: Regardless of how the taxpayer used the property before January 1, 2009, such use is not nonqualifying use for purposes of determining the exclusion available under Sec. 121.

Computation of Recognizable Gain on Property Subjected to Nonqualified Use

The amount of gain allocable to periods of nonqualified use and ineligible for exclusion is the product of:

1. The total amount of gain and
2. A fraction composed of:
 - a. A numerator, which is the sum of all the periods of nonqualified use during the period the property was owned by the taxpayer; and
 - b. A denominator, which is the entire period the property was owned by the taxpayer (Sec. 121(b)(4)(B)(ii)).

Regardless of whether the home appreciates significantly after its conversion from a nonqualified use property to a taxpayer's principal residence, the taxpayer

computes the amount of gain ineligible for exclusion using the above formula.

Any period of nonqualified use occurring before January 1, 2009, does not factor into the fraction used above and has no bearing on the determination of the recognizable gain.

Example 1: *T*, a single individual, purchases a second home in Florida on January 1, 2009, for \$500,000. From January 1, 2009, until January 1, 2012, *T* vacations in this home and resides in his principal residence in Georgia. On January 1, 2012, after retiring and selling his Georgia residence, *T* moves to his Florida home and converts the vacation property into his principal residence. On January 1, 2014, *T* sells the Florida home for \$750,000.

Of the \$250,000 gain on the sale of his Florida home, only 40%, or \$100,000, is eligible for the Sec. 121 exclusion. The result is a product of the total gain (\$250,000) multiplied by the fraction of which the numerator is the initial three-year period (January 1, 2009–January 1, 2012) of nonqualified use as a vacation home before conversion into a primary residence and the denominator is the five-year period of ownership ending January 1, 2014. Thus, *T* pays tax at the existing capital gains rate on \$150,000 of gain. Before this law change, the entire gain would have been excluded.

Nonqualified Use Extends Beyond "Residence"

The new amendments to Sec. 121 use the word "property" rather than "residence" to ensure the broad application of the provision. It therefore appears that the definition of nonqualifying use includes the period of time that a taxpayer owns a vacant lot on which he or she intends to construct his or her primary residence before that residence is constructed and occupied so as to be construed as the taxpayer's primary residence. In addition, the period of time spent remodeling or upgrading a newly acquired residence before a taxpayer moves into this residence is likely to be deemed nonqualifying use under Sec. 121(b)(4)(C)(i).

Key Exception #1: Property First Held as Primary Residence

Homeowners can move out of their primary residence and convert it to nonqualified use property such as rental, investment, or vacation property and still be eligible for the full exclusion. The determination of the availability of the full exclusion in this instance rests with the homeowner's qualifying for the other requirements of Sec. 121 (i.e., own and occupy the primary residence for at least an aggregate of 24 of the past 60 months ending on the date of sale) at the date of disposition.

Example 2: B, a single individual, resides in her principal residence in Georgia, which she acquired for \$300,000, for a consecutive 24-month period beginning January 1, 2009, and ending January 1, 2011. On January 1, 2011, B acquires a second home in Colorado and converts this home into her principal residence. For the three-year period beginning January 1, 2011, and ending January 1, 2014, B owns and maintains her Georgia residence as a second home. However, on January 1, 2014, B sells her Georgia residence for \$550,000, realizing a \$250,000 gain on the sale.

B may exclude the entire \$250,000 of gain realized on the disposition of her primary residence. The exclusion is still available because, under Sec. 121(b)(4)(C)(ii), a period of nonqualified use does not include any portion of the five-year testing period.

In other words, because the period of time that B did not use the residence as her principal residence occurred after the last date that she used the residence as her principal residence during the Sec. 121(a) five-year testing period, such a period will not be deemed a period of nonqualified use.

Key Exception #2: Temporary Absence

Under Sec. 121(b)(4)(C)(ii)(III), a period of nonqualified use does not include a period of temporary absence, which is defined as a period of absence "due to a change of employment, health conditions, or such other unforeseen circumstances,"

with the period not exceeding an aggregate of two years.

The Sec. 121(b)(4)(C)(ii)(III) "temporary absence" exception is drafted using wording similar to that of the partial exclusion exception of Sec. 121(c)(2)(B). Therefore, taxpayers may be wise to ensure compliance with the existing partial exclusion safe-harbor provisions and the accompanying statutory law, case law, and IRS guidance surrounding these provisions before seeking shelter under the temporary absence exception.

Example 3: S, a single individual and a resident of Georgia, purchases a home in Florida on September 1, 2010, which she intends to immediately move into and use as her principal residence. However, two weeks after purchasing her Florida home, a hurricane severely damages the Florida property, forcing S to continue using her Georgia home as her primary residence. On September 1, 2011, when the Florida property is fully repaired, S moves into this home and maintains the property as her primary residence until she sells the home on September 1, 2016. Because the one-year period of absence from the Florida home was caused by unforeseen circumstances, S is still able to exclude the full \$250,000 of gain on the sale of her Florida home on September 1, 2016.

Effect of Nonqualified Use on Sec. 1031 Exchanges

Previously, taxpayers acquiring replacement property via a Sec. 1031 exchange could, after holding the property for productive use in a trade or business or for investment purposes for a period of time, convert such property into a primary residence and avail themselves of the full exclusion under Sec. 121 upon the ultimate disposition of such property.

However, because of the nonqualified use rules, the full \$250,000/\$500,000 exclusion will no longer be available on the disposition of property acquired via a Sec. 1031 exchange that a taxpayer later converts into a primary residence. This occurs because the nonrecognition rules of Sec. 1031 prohibit the use of a principal

residence as replacement property immediately after the exchange, thus giving rise to a period of nonqualified use following the tax-free exchange.

Similar to the pre-Housing and Economic Recovery Act law, in order to take advantage of the Sec. 121 exclusion on replacement property acquired via a Sec. 1031 exchange, the homeowner must:

- Own and occupy the property as his or her principal residence for an aggregate two-year period during the five-year period ending on the date of the sale; and
- Under Sec. 121(d)(10), own the property for at least five years before selling it.

Tax Planning Strategies

Time is running out for taxpayers to be able to take advantage of the transition period because the new rules take effect on January 1, 2009. Taxpayers could, by ensuring that their second home is converted into their primary residence before January 1, 2009, avail themselves of the full Sec. 121 exclusion on the ultimate disposition of multiple residences.

Such a strategy may be available for taxpayers who own and occupy a primary residence that, as of January 1, 2009, meets the 24-month ownership and use requirements and who, on or before January 1, 2009, are able to convert a second residence into their primary residence.

Taxpayers in this position may convert their current primary residence into a second residence on or before January 1, 2009, and, assuming that the ultimate disposition of their current primary residence does not fall outside the five-year time period of Sec. 121(a), take advantage of the full Sec. 121 exclusion as before the 2008 Housing and Economic Recovery Act.

In order to ensure that the full exclusion is also available for a property originally acquired as a second home, the second home must be converted into the taxpayer's primary residence on or before January 1, 2009. Taxpayers should take measures to ensure that this property is properly deemed the taxpayer's primary residence. Such measures include:

1. Spending a majority of time during the year at this residence; and

2. Ensuring that the address of the recently converted home is the address listed on the taxpayer's tax returns, driver's license, automobile registration, voter registration card, bills, correspondence, etc.

While such factors are certainly relevant, taking such measures does not automatically ensure the availability of the full Sec. 121 exclusion because the determination of a taxpayer's principal residence is based on all the facts and circumstances.

Finally, taxpayers facing taxable gains should spend additional time maintaining detailed records documenting tax basis and all improvements to the property.

From Kevin Rose, CPA, CFP, Frazier & Deeter, LLC, Atlanta, GA

INTEREST INCOME & EXPENSE

Certain Debt Obligations Not Subject to AHYDO Restrictions

As a result of the recent deteriorating market conditions for debt obligations, the IRS has indicated that it will not regard specific debt obligations as applicable high-yield discount obligations (AHYDO) for purposes of Secs. 163(e)(5) and 163(i).

Generally, when a corporation issues a debt obligation subject to the AHYDO rules, the disqualified portion of the original issue discount (OID) is considered to be a distribution akin to a dividend, rendering that portion nondeductible for tax purposes. The corporation defers the deduction for the remaining amount of OID until it is actually paid. Original issue discount is the discount from par value at the time a bond or other debt obligation is issued; it is the difference between the stated redemption price at maturity and the issue price (Sec. 1273(a)(1)).

Many tax professionals may be confused by the AHYDO rules or even unaware of the provisions. The recent market collapse for debt obligations makes having a working knowledge in this area more important than ever.

Rev. Proc. 2008-51

The IRS recently provided guidance on AHYDO in Rev. Proc. 2008-51, which is effective for debt obligations issued on

or after August 8, 2008. This revenue procedure was issued to provide assurance to those who may have obtained financing commitments and, as a result of the recent deteriorating market conditions, discovered that the related debt obligation issue price may be significantly less than the monies advanced to the company under the financing commitment. In addition, certain mitigating actions may be necessary to reduce the impact of the reduced market price for debt obligations that, without this guidance, might lead one to conclude that the AHYDO rules do apply to the modified or exchanged obligation.

The new guidance provides more certainty with respect to certain potential AHYDO tax issues that may be affected by the issuance of specific debt obligations. The new guidance applies to debt obligations issued for money under a financing commitment and debt obligations issued in exchange for debt obligations issued under a financing commitment.

In anticipation of its needs, a company may seek to obtain a financing commitment from its lender in advance of borrowing the needed funds. These commitments guarantee that the company will have adequate debt financing at an upcoming date. When the company calls upon the commitment and the lender extends credit under terms previously negotiated, the company will borrow on those terms that were established in the commitment.

These terms may remain fixed over the term of the debt obligation. Fixed terms may allow the debt to be quickly sold by the lender. On the other hand, the company may borrow on terms that are temporary but that change to fixed terms after this temporary period. If the terms are temporary, the company may refinance the loan during the bridge period on terms that are more favorable than the fixed terms.

As recent market actions have shown, conditions can worsen between the time a company obtains a binding commitment and the time the company calls upon the lender to perform. This can have a number of consequences that may result in situations in which the issue price of a

debt obligation is significantly less than the amount of money actually received by the company. For example, the lender may be unable to sell the debt to third parties for a price near the amount provided to the company under the commitment. In these situations, the issue price of the debt may be significantly less than the amount of money advanced to the company.

The issuance of a debt obligation under a commitment or under the significant modification of a debt obligation could subject the borrower to adverse income tax consequences in situations in which the issue price of the debt obligation is less than the cash actually received by the company. For example, interest deductions on the debt obligation may be disallowed under Sec. 163(e)(5) (i.e., the AHYDO rules could be applicable).

Under Sec. 163(e)(5), in the case of an AHYDO, a company is not allowed a deduction for the disqualified portion of the OID on the obligation, and the company's deduction for the remaining portion of the OID is deferred until the OID is paid in cash or in property.

A debt obligation is an AHYDO if:

1. The maturity date of the debt obligation is more than five years from the date of issue;
2. The yield to maturity of the debt obligation equals or exceeds the sum of the applicable federal rate in effect under Sec. 1274(d) for the calendar month in which the obligation is issued, plus five percentage points; and
3. The debt obligation has significant OID (Sec. 163(i)).

Under Sec. 163(i)(2), a debt obligation has significant OID if:

1. The aggregate amount that would be includible in gross income with respect to the debt obligation for periods before the close of any accrual period (as defined in Sec. 1275(a)(5)) ending after the date five years after the date of issue exceeds
2. The sum of the aggregate amount of interest to be paid under the debt obligation, before the close of the accrual period, and the product of the issue price of the debt obligation (as defined in Secs. 1273(b) and 1274(a)) and its yield to maturity.

Three Scenarios Addressed

Rev. Proc. 2008-51 applies to three scenarios. In the first, a debt obligation is issued for money under a financing commitment. If the following conditions are satisfied, the IRS will not treat the debt obligation as an AHYDO for purposes of Secs. 163(e)(5) and 163(i):

1. The debt obligation is issued by a corporation;
2. The debt obligation is issued for money and the terms of the debt obligation are consistent with the general terms of a binding financing commitment obtained by the company from an unrelated party before January 1, 2009; and
3. The debt obligation would not be an AHYDO within the meaning of Sec. 163(i) if, solely for purposes of making a determination if it is an AHYDO, the issue price of the debt obligation were the net cash proceeds actually received by the company for the debt obligation.

In the second scenario, a debt obligation is issued in exchange for another debt obligation issued under a financing commitment. The IRS will not treat the debt obligation as AHYDO if:

1. A corporation issues a debt obligation and the debt obligation is issued in exchange for a previous debt obligation that meets the requirements described in Scenario 1 above issued by the corporation;
2. The new debt obligation is issued within 15 months following the issuance of a previous debt obligation, and the debt obligation would not be an AHYDO within the meaning of Sec. 163(i) if, solely for purposes of making a determination of whether the debt obligation is an AHYDO, the issue price of the debt obligation were the net cash proceeds actually received by the company for the previous debt obligation; and
3. The maturity date of the debt obligation may not be more than one year later than the maturity date of the previous debt obligation, and the stated redemption price at maturity of the debt obligation is not greater than the stated redemption price at maturity of previous debt obligation.

The third scenario applies to a debt obligation indirectly exchanged for a debt obligation issued under a financing commitment. This scenario will not result in an AHYDO if:

1. A corporation issues a debt obligation;
2. The debt obligation is issued in exchange for a previous debt obligation (old debt B) issued by the corporation that meets the requirements described in Scenario 2;
3. The new debt obligation is issued within 15 months following the issuance of another debt obligation (old debt A);
4. The new debt obligation would not be an AHYDO within the meaning of Sec. 163(i) if, solely for the purpose of determining whether it is an AHYDO, the issue price of the debt obligation were the net cash proceeds actually received by the company for A;
5. The maturity date of the debt obligation is not more than one year later than the maturity date of A; and
6. The stated redemption price at maturity of the debt obligation is not greater than the stated redemption price at maturity of A.

Conclusion

In the current and recent market environment of commercial debt obligations, the AHYDO rules are certain to generate confusion among taxpayers. Advisers should be aware of the application of the AHYDO rules, including the new rules in Rev. Proc. 2008-51.

From Mark G. Cook, CPA, MBA, Singer-Lewak LLP, Irvine, CA (not affiliated with CPAmerica International)

PERSONAL FINANCIAL PLANNING

Taxation of Long-Term Care Insurance

Today, medical science allows people to live longer, meaningful, independent lives; however, it is still likely that elderly individuals will become ill and need care. Long-term care (LTC) is a topic often avoided, but for many individuals it will prove to be one of the most significant issues they will have to deal with during their lifetime. Discussing LTC insurance should be a priority for all professional

advisers in order to help protect the best interests of their clients and families as they enter the “golden years” of their lives.

Qualified LTC Insurance Policy

Qualified LTC insurance policies are allowed special tax treatment. However, an LTC policy can cover only qualified long-term care services (defined below). Under Sec. 7702B(b), the contract must:

- In general not pay for or reimburse expenses incurred for services or items if the expenses are reimbursable under Medicare;
- Be guaranteed renewable;
- Not provide for a cash surrender value or all refunds of premiums, and all policyholder dividends under the contract must be applied as a reduction in future premiums or to increase future benefits; and
- Include certain consumer protection clauses.

Under Sec. 7702B(g), an LTC policy is considered to meet the consumer protection requirements if it includes provisions relating to:

1. National Association of Insurance Commissioners model regulations, including:
 - Guaranteed renewal or noncancellability;
 - Prohibitions on limitations and exclusions;
 - Extension of benefits;
 - Continuation or conversion of coverage;
 - Discontinuance and replacement of policies;
 - Unintentional lapse;
 - Disclosure;
 - Prohibitions against post-claim underwriting;
 - Minimum standards;
 - Offers of inflation protection; and
 - Prohibition of preexisting conditions and probationary periods in replacement policies or certificates.
2. Disclosure requirements under Sec. 4980C, including those related to:
 - Application forms and replacement coverage;
 - Reporting requirements;
 - Filing requirements and standards for marketing;

- Appropriateness of recommended purchase;
 - Standard format of coverage;
 - Requirements to deliver a shopper’s guide;
 - Right to return;
 - Requirements for certificates under group plans;
 - Policy summaries;
 - Monthly reports on accelerated death benefits;
 - Incontestability period; and
 - Policy disclosures in the outline of coverage that the policy is intended to be a qualified LTC insurance contract under Sec. 7702B.
3. Nonforfeiture requirements, including (Sec. 7702B(g)(4)):
- The nonforfeiture provision shall be appropriately captioned;
 - The nonforfeiture provision shall provide for a benefit in the event of a default in the payment of any premiums;
 - The amount of the benefit may be adjusted only to reflect certain factors subsequent to the policy being initially granted; and
 - The nonforfeiture provision shall provide at least one of the following: (1) reduced paid-up insurance, (2) extended term insurance, (3) a shortened benefit period, or (4) other similar offerings approved by the appropriate state regulatory agency.

Qualified Long-Term Care Services

An individual must receive qualified LTC services before filing claims under a qualified LTC policy. Qualified LTC services are defined as necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and are provided under a plan of care prescribed by a licensed health care practitioner (Sec. 7702B(c)(1)).

The term “chronically ill individual” means any individual who has been certified by a licensed health care practitioner within the prior 12 months as (Sec. 7702B(c)(2)):

1. Being unable to perform (without substantial assistance from another individual) at least two activities of daily living for a period of at least 90 days due to a loss of functional capacity (activities of daily living include eating, toileting, transferring, bathing, dressing, and continence). A qualified LTC insurance contract must take into account at least five such activities in determining whether an individual is chronically ill.
2. Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

Taxation of LTC Insurance

Eligible premiums paid for LTC insurance are deductible as medical expenses for individuals subject to the 7.5% adjusted gross income limitation (Sec. 213(d)). For 2008, deductible amounts for eligible premiums based on age are as follows (Rev. Proc. 2007-66):

Age before close of tax year	2008 limitation
≤40	\$ 310
41–50	580
51–60	1,150
61–70	3,080
> 70	3,850

Amounts reimbursed under an LTC policy for actual costs incurred are excludible from income. Amounts received under a per diem type policy are not included in income unless the amounts received during the year exceed the greater of (1) actual costs incurred or (2) \$270 per day (indexed for 2008) (Sec. 7702B(d); Rev. Proc. 2007-66).

The Future

According to data compiled by the U.S. Department of Health and Human Services National Clearinghouse for Long-Term Care Information, on average an individual who is 65 years old today will require three years of long-term care during his or her life (www.longtermcare.gov/LTC/Main_Site/Understanding_Long_Term_Care/Basics/Basics.aspx). The Department of Health and Human Services

also estimates that the cost of a private room in a nursing home is approximately \$76,000 a year, while an assisted living facility costs approximately \$36,000 (www.longtermcare.gov/LTC/Main_Site/Paying_LTC/Costs_Of_Care/Costs_Of_Care.aspx). Although state-funded programs are available, many will require the individual to liquidate assets (subject to specific state laws) before becoming eligible for state funding assistance. Not all nursing homes and assisted living facilities accept the limited funding provided by state programs, which may cause an individual to be admitted to a facility based on finances instead of personal choice. LTC insurance can help individuals retain their independence and comfort and allow them to live out their lives with dignity and respect.

From Carl Sasaki, CPA, Singer Lewak LLP, Woodland Hills, CA (not affiliated with CPAmerica International)

STATE & LOCAL TAXES

California Combined Report Includes Unitary Insurance Subsidiary

In a recent letter decision, the California State Board of Equalization (SBE) ruled that a taxpayer’s combined report should include a wholly owned unitary insurance subsidiary (SBE Letter Decision No. 361467, Appeal of Electronic Data Systems Corp. (8/8/08)). In addition, the decision held that the premiums received from the subsidiary’s Texas insurance operations should be included in the calculation of the parent company’s sales factor.

Background

Electronic Data Systems Corporation (EDS) filed California franchise tax returns for the years ended December 31, 1997, and December 31, 1998. EDS had a unitary insurance subsidiary, National Heritage Insurance Company (NHIC), which conducted an insurance business in Texas and also conducted a noninsurance business in California. NHIC was qualified to do business as an insurance company in Texas and was regulated by the Texas Department of Insurance.

EDS excluded NHIC from its combined reports for the years at issue. On audit, the California Franchise Tax Board (FTB) auditor determined that NHIC should be included in the EDS combined report. In computing the California sales factor, the auditor did not include premiums received by NHIC from its insurance business in the sales factor denominator.

EDS protested the auditor's findings and later filed an appeal asserting that the auditor was correct that NHIC should be included in EDS's combined reports and further asserted that the premiums from NHIC's Texas insurance activities should be reflected in its sales factor.

Inclusion in Combined Report

EDS originally excluded NHIC from its combined reports for the years at issue, relying on FTB Legal Ruling 385, Treatment of Insurance Company Affiliates for Combined Reporting Purposes (3/28/75). In addressing that ruling, the SBE found that the ruling's basic holding was that in-state insurance affiliates must be excluded from a combined report. Legal Ruling 385 stated that its holding also applied when an affiliated insurance company operated "entirely outside of California."

Thus, Legal Ruling 385 could be read two ways. First, it could apply whenever the unitary affiliate conducted its insurance business entirely outside California, whether or not it conducted any other business in California. Second, the ruling could be read to apply only when the unitary affiliate conducted all its business outside California.

Given that Legal Ruling 385 could be interpreted in two ways, the question became one of deference to the legal ruling's holding. The SBE found that "[w]hen the Board is acting in its quasi-judicial capacity in hearing an appeal from the FTB, a Legal Ruling is entitled to an appropriate degree of respect and deference, but is not necessarily binding." The SBE went on to say that it has the authority to render its own opinion of the underlying law "using all the tools at its disposal," including relevant statutory and constitutional provisions.

In determining that NHIC should be included in EDS's combined report, the

SBE observed that taxpayers engaged in a unitary business must file a combined report (CA Rev. & Tax. Code §25101). The SBE found that there was agreement that NHIC was a taxpayer and that EDS and NHIC were engaged in a unitary business.

Further, Article XIII, Section 28, of the California constitution did not preclude NHIC from being subject to the franchise tax. Section 28 imposes a gross premiums tax on insurance companies. This tax is "in lieu of all other taxes and licenses, state, county, and municipal" except for real estate taxes and motor vehicle taxes and licenses. Thus, insurance companies are exempt from the corporate income and franchise tax. The exemption also covers income from noninsurance activities. However, the California Supreme Court has stated that the "tax is on 'gross premiums . . . received . . . by such insurer upon its business done in this state.' . . . If the insurer does no *insurance* business here, there are no gross premiums received and section 28 does not apply" (*Mutual Life Ins. Co. of NY v. City of Los Angeles*, 50 Cal. 3d 402 (1990)). NHIC did no insurance business in California, so Section 28 did not apply and thus did not preclude NHIC from being subject to the franchise tax.

Inclusion of Insurance Company Premiums in the Sales Factor

On audit, the FTB auditor determined that NHIC should be included in the EDS combined report. The auditor did not include premiums received by NHIC from its insurance business in computing the California sales factor.

After analyzing whether the premiums were gross receipts includible in the sales factor and whether the standard apportionment formula fairly represented EDS's business activity in California, the board concluded that the calculation of the sales factor should include the premiums received by NHIC from its insurance operations in Texas.

Petition for Rehearing

The above decision would have become final 30 days from the board's August 8, 2008, decision date unless EDS or the

FTB filed a petition for rehearing. The FTB did file such a petition. Practitioners and similarly situated taxpayers should monitor the outcome of the rehearing closely because it could result in planning opportunities as well as traps for the unwary.

From Edward Sakurai, CPA, J.D., Singer Lewak LLP, Los Angeles, CA (not affiliated with CPAmerica International)

Continued Trend Toward State Related-Party Expense Addback

In recent years, several states have enacted provisions requiring the addback of certain related-party expenses. These provisions are intended to combat the use of related-party transactions to reduce the taxable income of an affiliated company that files in a separate-company reporting state and reflect the continued trend by states to enact some form of related-party expense addback. The trend started in the 1990s and accelerated into the early 2000s. Since 2005, six additional states have enacted legislation limiting the deductibility of related-party expenses, with the latest being Michigan, Rhode Island, and Wisconsin, whose provisions are effective for 2008 tax years.

In the past, taxpayers have been able to take deductions for certain expenses payable to related parties, including interest and expenses relating to the licensing of intangibles. These deductions could have the effect of lowering taxpayers' overall state tax burden.

For example, a company would transfer its valuable intangibles into a separately incorporated subsidiary. That subsidiary typically would be organized in Delaware, which does not tax such companies. The subsidiary could also be organized in a state with no state income tax, such as Nevada. There is also benefit derived if the subsidiary is organized in a combined reporting state. The intangible company would license its intangibles to the operating company and charge the operating company a royalty or license fee. The operating company would take a deduction for the expense on its separate company state tax return, but the recipient

of the income—the intangible company—would not pay tax on the corresponding income because such income is not subject to tax.

To combat this type of tax planning, states have enacted provisions that disallow the deduction of these related-party expenses. The common targets of such disallowance are interest expenses and expenses related to the licensing of intangibles.

Recognizing that in certain circumstances there is a legitimate business purpose behind related-party financing arrangements and intangible licensing arrangements, states generally provide exceptions where addback is not required by the payor. These exceptions vary depending on the state, but some common exceptions include:

- Where the principal purpose of the arrangement is not tax avoidance, the transaction is made at arm's-length rates, or the taxpayer shows that the adjustment is unreasonable;
- Where the corresponding income is subject to tax (many states provide that no addback is required where the related member is subject to a net income or capital-based tax by that state, another state, or a foreign government; some states require that the income be taxed at a certain rate);
- Where the corresponding income is paid by the recipient to an unrelated third party (the recipient merely acts as a conduit in the ultimate payment to a third party);
- Where the taxpayer enters into an agreement to use an alternative apportionment method.

Michigan

The Michigan business tax (MBT) has been enacted and replaces the Michigan single business tax (SBT) effective January 1, 2008. The SBT did not require an addback for related-party expenses, but the new MBT requires an addback for any royalty, interest, or other expense paid to a person related to the taxpayer for the use of an intangible asset if that person is not included in the taxpayer's unitary business tax return (MI Comp. Laws §208.1201(2)(f)). The new MBT requires

unitary groups to file a combined return (MI Comp. Laws §208.1511).

Addback is not required if the taxpayer can demonstrate that the transaction has a nontax business purpose other than the avoidance of tax, is conducted with arm's-length pricing and rates as applied in accordance with Secs. 482 and 1274(d), and meets one of the following requirements:

1. The transaction is a passthrough of another transaction between a third party and the related person with comparable rates and terms;
2. The transaction results in double taxation; or
3. The addback is unreasonable as determined by the treasurer.

Rhode Island

Rhode Island has enacted legislation requiring the addback of related-party expenses effective for tax years beginning on or after January 1, 2008. Specifically, Rhode Island now requires an addback of otherwise deductible interest and intangible expenses paid or accrued to related parties (RI Gen. Laws §44-11-11(f)).

Addback is not required where:

1. The taxpayer establishes by clear and convincing evidence that the adjustments are unreasonable or the taxpayer agrees to use an alternative apportionment method;
2. The taxpayer establishes by a preponderance of the evidence that the related member paid or accrued the income to an unrelated third party and the transaction did not have a significant purpose of tax avoidance; or
3. The taxpayer establishes by clear and convincing evidence that (a) the purpose of the transaction giving rise to interest expense was not tax avoidance, (b) the interest was paid at an arm's-length rate, and (c) the related member was subject to tax on its net income in Rhode Island or another state or possession of the United States or a foreign nation, the measure of tax included the interest received, and the effective tax rate applied to the interest was not less than the effective rate applied to the taxpayer minus 3%.

Wisconsin

Effective for tax years beginning on or after January 1, 2008, Wisconsin requires that interest and rent expenses paid, accrued, or incurred to a related party must be added back (WI Stat. §71.26(2)).

Addback is not required if the amount is disclosed and:

1. The related party to which the taxpayer paid, accrued, or incurred the interest or rental expenses paid, accrued, or incurred such amounts to an unrelated party;
2. The related party was subject to tax on, or measured by, its net income in Wisconsin or any other state, U.S. possession, or foreign country, and the aggregate effective tax rate applied to the income is at least 80% of the taxpayer's aggregate effective rate; or
3. The taxpayer establishes that the transaction has a business purpose other than the avoidance or reduction of tax, the transaction changed the taxpayer's economic position in a meaningful way apart from the tax effects, and the interest and/or rental expenses were paid at an arm's-length rate (WI Stat. §71.80(23)).

Conclusion

To date, almost half the states have provisions requiring addback of related-party expenses. Taxpayers can expect that along with the enactment of these provisions, increased audit activity will follow. Because each state's provisions requiring addback of related-party expenses, as well as the exceptions to addback, differ, a thorough understanding of each state's provisions is imperative to avoid unexpected tax exposure.

From Edward Sakurai, CPA, J.D., Tax Senior Manager, Singer Lewak LLP, Los Angeles, CA (not affiliated with CPAmerica International)

Massachusetts Corporate Tax Law Changes Effective in 2009

This summer Massachusetts enacted a law aimed at simplifying the corporate tax structure and raising revenue while cutting corporate tax rates (An Act Relative to Tax Fairness and Business Competitiveness,

stat. 2008, ch. 173, signed into law July 3, 2008). The major provisions include new unitary filing requirements; conformity with the federal check-the-box rules for state tax purposes, including disregarded entity status for qualified subchapter S subsidiaries (QSubs); and corporate rate reductions. The act also codifies that corporations protected from income taxation by P.L. 86-272 may be subject to the nonincome measure of the excise tax.

Unitary Filing

With this law, Massachusetts joins 22 other states in requiring corporations engaged in unitary business operations to file combined returns with their affiliates. With combined reporting, a corporation required to file on a combined basis must calculate its state taxable income based on the apportionable income of the combined group, and intercompany transactions will be disregarded. Under separate filing, each company includes on its return only its own income, leaving opportunity for tax planning by locating profitable businesses in lower-tax jurisdictions.

A group of corporations with common ownership is defined as “unitary” under the act if the corporations are “sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them” (MA Gen. Laws ch. 63, §32B(b)(1)). Common ownership is defined as more than 50% of voting control, whether such ownership is direct or indirect (MA Gen. Laws ch. 63, §32B(b)(2)).

Check-the-Box Rules

Federal check-the-box rules allow unincorporated businesses to elect for federal purposes whether they would be taxed as a corporation, partnership, or disregarded entity (Regs. Secs. 301.7701-1 through -3). This has created federal and state tax classification differences; for example, QSubs must currently file separately in Massachusetts for purposes of the nonincome measure of corporate tax. In addition, Massachusetts currently has separate tax provisions for corporate trusts.

With conformity with the federal check-the-box rules, the corporate trust



provisions are repealed, so beginning in 2009 the state return filed will depend on the federal tax treatment elected by the entity. Federal S corporations that were previously treated as corporate trusts in Massachusetts will be required to file as S corporations for Massachusetts purposes. In addition, QSubs will be disregarded for all Massachusetts corporate tax purposes and will no longer be required to file separate returns.

Corporate Excise Tax Reductions

Currently, C corporations in Massachusetts are taxed on net income at a rate of 9.5%, and large S corporations are taxed at 3% if total receipts are between \$6 million and \$9 million and at 4.5% if total receipts are \$9 million and above.

Starting in 2010, the tax rates will be gradually reduced to 8% on the following schedule (MA Gen. Laws ch. 63, §39):

- Tax years beginning on or after January 1, 2010: 8.75%.
- Tax years beginning on or after January 1, 2011: 8.25%.
- Tax years beginning on or after January 1, 2012: 8.00%.

The net income measure on large S corporations has been modified so that it is tied to the corporate rates above. Effective for tax years beginning on or after January 1, 2009, the net income measure on S corporations with \$9 million or more in total receipts will be equal to the corporate rate in effect less the individual rate then in effect. For S corporations with \$6 million

or more but less than \$9 million in total receipts, the rate will be two-thirds of the rate for larger S corporations. For 2009, the rates will be as follows (MA Gen. Laws ch. 63, §32D(a)(ii)):

- Total receipts of \$9 million or more: 9.5% – 5.3%, or 4.2%.
- Total receipts of at least \$6 million but less than \$9 million: 4.2% × $\frac{2}{3}$, or 2.8%.

Financial institutions are currently taxed at 10.5%, but the tax rate will be reduced to 9% as follows (for financial institutions that are not S corporations) (MA Gen. Laws ch. 63, §2(b)):

- Tax years beginning on or after January 1, 2010: 10.0%.
- Tax years beginning on or after January 1, 2011: 9.5%.
- Tax years beginning on or after January 1, 2012: 9.0%.

Where applicable, the act leaves the nonincome measure of the corporate excise unchanged.

From Michael D. Koppel, CPA, PFS, CITP, Gray, Gray & Gray, LLP, Boston, MA

Massachusetts Taxes All Contributions to 401(k) Plans by Self-Employed Individuals

On July 2, 2008, the Massachusetts Department of Revenue (DOR) issued Directive 08-3, The Massachusetts Income Tax Treatment of Contributions on Behalf of Partners and Other Self-Employed Individuals Under a 401(k) Plan. It concludes, based on MA Gen. Laws

ch. 62, §2(d)(1)(D), that contributions made to a 401(k) plan by self-employed individuals are not deductible for Massachusetts income tax purposes effective for tax years beginning on or after January 1, 2008 (meaning that the directive is effective retroactively). The directive provides that taxpayers do not have to amend returns from prior years.

For purposes of this directive, the DOR defines a self-employed person as anyone who receives self-employment income as defined in Sec. 401(c) and related regulations. Therefore, the directive will apply to proprietors, partners in a partnership, and members of an LLC taxed as a partnership. In 1999, the DOR issued Directive 99-4, which clearly indicated that the shareholders in an S corporation could deduct contributions to a 401(k) for Massachusetts income tax purposes.

Directive 08-3 makes clear that not only is the contribution made by the self-employed person not deductible, but any contributions made by the business for the benefit of the self-employed person are not deductible. This change can have a significant effect on a taxpayer's Massachusetts 2008 taxes.

Tax advisers need to warn affected taxpayers that this additional Massachusetts tax is coming. Depending on the taxpayer's situation, it may be beneficial to increase his or her fourth-quarter estimate and pay it in December to reduce the federal tax. Of course, if the taxpayer will be subject to the alternative minimum tax (AMT), accelerating the tax payment will not be beneficial because state income taxes are not deductible for AMT purposes (Sec. 164(a)).

The complications from this tax do not start with the additional tax. In order to prevent double taxation, when an affected taxpayer takes distributions from his or her 401(k) account in the future, a deduction will be allowed for the portion of the distribution that represents contributions that were taxed in the year they were made, provided that the taxpayer can substantiate the amount of the previously taxed contributions. Therefore, affected taxpayers will also have to keep track of the 401(k) contributions on which they

have paid Massachusetts income tax. The burden of maintaining this information will fall directly on taxpayers and their tax preparers.

The requirement to pay Massachusetts income tax in the year of contribution to a 401(k) may also affect a business's choice of entity. Because of the time value of money, a smaller business that will not be subject to the Massachusetts "sting tax" may elect to be an S corporation instead of a partnership or an LLC taxed as a partnership.

From Michael D. Koppel, CPA, PFS, CITP, Gray, Gray & Gray, LLP, Westwood, MA

State Research Credits

Congress recently extended the federal research credit under Sec. 41 for amounts paid or incurred before January 1, 2010, and certain states also provide credits for qualified expenditures. However, many states impose additional requirements on the computation of the state credits (e.g., activities must be conducted in the state or computations of base amounts differ) that are easily overlooked but can have substantial impact. Accordingly, it makes sense to revisit how these state rules might affect clients.

Note: At the time of this writing, more than half the states provide some sort of tax credit for expenses paid or incurred with respect to a taxpayer's qualified research activities. Because a review of each state's provisions is beyond the scope of this item, it will focus on some of the more interesting California provisions under CA Rev. & Tax. Code §23609. In addition, the federal and California research credit provisions also provide benefits for amounts paid for "basic research," but those are also outside the scope of this item.

Background

The federal research credit was originally enacted in 1981 and was intended in large part to spur domestic innovation. It took the form of a nonrefundable credit against income tax available to taxpayers for certain qualified expenditures that exceeded a defined base amount (Sec. 41(c)).

In computing the credit for both federal and California purposes, it is important to remember that there are various methods to consider, depending on whether the company had sufficient activity in the 1984–88 time period, whether the taxpayer wants to elect the alternative simplified method or the alternative incremental method, whether the taxpayer is a member of a group of businesses that must aggregate their activities, and so on.

However, for the sake of this discussion, the standard method of computing the credit is as follows (for both federal and California) for businesses that are not startups:

1. Take the total of the taxpayer's qualified research expenditures for tax years beginning after December 31, 1983, and before January 1, 1989.
2. Divide that total by total gross receipts for those same years. The resulting percentage is the fixed-base percentage, which, per Sec. 41(c)(3)(C), cannot be greater than 16%.
3. Take the average gross receipts for the four years preceding the current year and multiply that amount by the fixed-base percentage (Sec. 41(c)(1)). The result is the tentative base amount.
4. Compare the tentative base amount against the current-year qualified expenditures.

If the current-year qualified expenditures are less than the tentative base amount, no research credit is available. If the current-year qualified expenditures are greater than the tentative base amount, the increment is the lesser of (1) the difference between the total current-year qualified expenditures and the tentative base amount or (2) one-half of the current-year qualified expenditures (Sec. 41(c)(2)).

The credit is then determined by multiplying the credit rate (20% federal (Sec. 41(a)), 15% California (CA Rev. & Tax. Code §23609(b))) by the increment as calculated above.

Finally, taxpayers need to decide if they prefer to elect under Sec. 280C(c)(3) to reduce the research expense credit and deduct the expenses under Sec. 174.

Note: In this context, a startup company is one that had both qualified research expenses and gross receipts either (1) for

Exhibit: State and federal research credit calculation

Assumptions:

- Taxpayer develops new/improved products for sale to customers
- All qualified activities are conducted in California
- Current tax year is 2007

	Federal	California
[a] Total QREs* (1984–88)	8,000,000	8,000,000
[b] Total gross receipts (1984–88)	100,000,000	15,000,000
[c] Tentative fixed base percentage ([a] ÷ [b])	8%	53%
[d] Fixed base percentage (lesser of [c] or 16% (Sec. 41(c)(3)(C))	8%	16%
[e] Average gross receipts (2003–6)	250,000,000	40,000,000
[f] Base amount ([d] × [e])	20,000,000	6,400,000
[g] QREs (2007)	12,000,000	12,000,000
[h] Excess over base amount (greater of ([g] – [f], 0))	0	5,600,000
[i] Research credit rate	20%	15%
Research credit amount ([h] × [i])	0	840,000

* QREs = qualified research expenditures

the first time in a tax year beginning after December 31, 1983, or (2) for fewer than three tax years beginning after December 31, 1983, and before January 1, 1989.

California Research Credit

The California research credit (effective as of 1987), while based on the federal credit, does contain some notable differences. In the right circumstances, those differences sometimes provide substantial (and unexpected) benefits to those who read the California rules carefully.

The first key difference in the California rules restricts the credit by the location of the qualifying activity. Specifically, CA Rev. & Tax. Code §23609(c)(2) provides that qualified research includes only research conducted in California. While it makes sense that California does not want to provide incentives outside the state, it places the responsibility on the taxpayer to ensure not only that its in-house expenses (e.g., wages or supplies) are for California activities but that its contract research expenses are as well. This means that the taxpayer must be able to establish that its subcontractors performed their work in California as well as to qualify those expenses for the California research credit.

The second key difference is one with which many California practitioners seem unfamiliar. That provision is in §23609(h)(3), which reads as follows:

Section 41(c)(6) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale.

In addition, California FTB Publication 1082, *Research & Development Credit: Frequently Asked Questions* (2008), provides the following (in relevant part):

Excluded receipts are items such as California "throwback" sales for apportionment purposes, as well as receipts from services, rents, operating leases and interest. In addition, royalties and license payments are generally excluded from the definition of gross receipts for research credit purposes. . . . This California definition of gross receipts applies to both the average annual gross receipts

for the prior four years and the base years (1984–1988).

Caution: While the publication does not have the weight of statutory authority, it is seemingly consistent with the statutory language noted above and does represent the Franchise Tax Board's official stance, so practitioners should not ignore it.

As innocuous as this second difference may seem, it represents a fundamental conceptual difference in the computation of the California credit. In short, it redefines gross receipts for California purposes as basically including only inventory sales to California purchasers.

So what does this really mean? Not only should practitioners expect the fixed base percentage to usually differ for federal and California computations, it also means that average gross receipts for the preceding four years will usually differ as well. Moreover, this can (in the right circumstances) provide a large and often beneficial difference to the taxpayer, where California gross receipts are substantially smaller than total gross receipts for federal purposes.

For the sake of illustration, consider the simple example in the exhibit.

What this example demonstrates is that a taxpayer blindly using the federal rules in this case would have erroneously forgone \$840,000 of California research credits to which it was entitled.

Conclusion

Relatively few practitioners seem to be well versed in the intricacies of state research credits. However, as shown in the exhibit, practitioners with clients conducting qualified research could find some hidden gems among state research credits.

From Andrew Gantman, CPA, Singer Lewak LLP, Woodland Hills, CA (not affiliated with CPAmerica International)

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EditorNotes

Michael Koppel is with Gray, Gray & Gray, LLP, in Westwood, MA.