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A flurry of legislation was passed by Congress at the end of 2007—including the Mortgage Forgiveness Debt Relief Act of 2007, the Tax Technical Corrections Act of 2007, the Energy Independence and Security Act of 2007 and the Virginia Tech Victim's Relief Act. The new legislation contained provisions impacting many taxpayers.

**FORGIVENESS OF DEBT**

Under preexisting law, the debt forgiven by a lender, such as for short sales and refinances, was generally taxable to the borrower as debt discharge income. With the passage of the Mortgage Forgiveness Debt Relief Act of 2007, a taxpayer does not have to pay federal income tax on up to \$2 million of debt forgiven for a loan secured by a qualified principal residence. The change in the tax law applies to debts discharged from January 1, 2007 to December 31, 2009. Here are the details.

***Discharge of indebtedness income: background.***

For income tax purposes, a discharge of indebtedness—that is, a forgiveness of debt—is generally treated as giving rise to income that's includible in taxable income. However, a discharge of indebtedness doesn't give rise to gross income if it: (1) occurs in a Title 11 bankruptcy case, (2) occurs when the taxpayer is insolvent, (3) is a discharge of qualified farm indebtedness, or (4) is a discharge of qualified real property business indebtedness.

Under pre-2007 Mortgage Relief Act law, there were no special rules applicable to discharges of acquisition debt on the taxpayer's principal residence. For example, assume a taxpayer who isn't in bankruptcy and isn't insolvent owns a principal residence subject to a \$200,000 mortgage debt for which the taxpayer has personal liability. The creditor forecloses and the home is sold for \$180,000 in satisfaction of the debt. Under pre-2007 Mortgage Relief Act law, the debtor had \$20,000 of debt discharge income.

The result was the same if the creditor restructured the loan and reduced the principal amount to \$180,000.

***New law relief provision.***

The 2007 Mortgage Relief Act excludes from a taxpayer's gross income any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness before Jan. 1, 2010. The exclusion applies where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure. For example, assume the same facts as in the example above except that the discharge occurs in 2008. Under the 2007 Mortgage Relief Act, the debtor has no debt discharge income when the creditor (1) restructures the loan and reduces the principal amount to \$180,000 or (2) forecloses with the result that the \$200,000 debt is satisfied for \$180,000.

The new relief provision does not apply to discharges of second mortgages or home equity loans in most cases.

**FAILURE TO FILE PARTNERSHIP AND S CORPORATION RETURNS**

***Partnership and S corporation failure to file penalty increased.***

Under pre-Mortgage Relief Act law, any partnership or S corporation required to file a return for any year, which failed to file on time (including extensions) or whose return failed to show the information required, was liable for a monthly penalty equal to \$50 times the number of persons who were partners during any part of the tax year, for each month or fraction of a month for which the failure continued. However, the total penalty could not be imposed for more than five months.

The Mortgage Relief Act extends the period for calculating the monthly failure-to-file-penalty for partnership and S corporation returns from 5 to 12 months and increases the per-partner penalty amount from \$50 to \$85 per partner, effective for returns required to be filed after Dec. 20, 2007. Note also that under the Virginia Tech Victim's Relief Act, for tax years beginning in 2008 only, the dollar amount per partner or per shareholder is increased by \$1. Thus, for tax years beginning in 2008, the per partner or per shareholder penalty for failure to file a partnership return is \$86.

**GROSS VALUATION MISSTATEMENTS**

In the 2006 Pension Protection Act, a penalty was added for substantial and gross valuation misstatements attributable to incorrect appraisals. That legislation omitted application of the penalty to substantial valuation understatements for estate and gift tax purposes. The Tax Technical Corrections Act of 2007 clarifies that the penalty applies for such purposes. The 2006 Pension Protection Act made another omission in the cross references for the penalty where the language relating to the time period for assessment of the penalty was not properly described. The new legislation corrects that error by providing that the penalty for valuation misstatements attributable to incorrect appraisals is subject to a 3-year limitation period.

**IRS TARGETS REIMBURSEMENT PLANS THAT RECHARACTERIZE WAGES**

IRS has established a cross divisional team to address significant concerns with employee tool and equipment plans that purport to be valid accountable plans. Taxpayers that are considering implementing these plans, which are widely marketed to various industries, including the automotive, heavy equipment, construction, aircraft maintenance, agriculture, and other industries, are cautioned to be wary of them.

***Background on accountable-plan rules.*** Reimbursements are tax-free to the employee and aren't subject to withholding or payroll taxes if made under an accountable plan. To be treated as made under an accountable plan, a reimbursement must meet all of the following requirements:

- (1) The reimbursed expense must be allowable as a deduction and must be paid or incurred in connection with performing services as an employee of the employer; (Reg. § 1.62-2(d)(1))
- (2) Each reimbursed expense must be adequately accounted for to the employer within a reasonable period of time; (Reg. § 1.62-2(e)) and
- (3) Any amounts in excess of expenses must be returned within a reasonable period of time. (Reg. § 1.62-2(f))

If a payor's reimbursement or other expense allowance arrangement shows a pattern of abuse, all payments made under the arrangement are treated as made under a nonaccountable plan (and thus are taxable wages, subject to withholding). (Reg. § 1.62-2(k))

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