# Chapter 7: Individual Taxpayer Topics



Corrections were made to this material through January of 2012. No subsequent modifications were made.

## HEALTHCARE COVERAGE FOR CHILDREN UNDER AGE 27

Because of changes made by the Patient Protection and Affordable Care Act[1] (PPACA) and the Health Care and Education Reconciliation Act[2] (HCERA), group health plans that offer coverage for dependent children must also offer coverage for children who are under age **26**. In April 2010, the IRS issued a notice providing guidance on the tax treatment of such healthcare coverage.[3]

### GROSS INCOME EXCLUSION FOR HEALTH BENEFITS

Certain health-related benefits are **excluded** from gross income. These include:

1. The value of coverage under an employer-provided accident or health plan;
2. Payments received by employees under IRC §105 medical reimbursement plans;
3. Pretax salary-reduction contributions for accident or health benefits under a cafeteria plan (including a health flexible spending account);
4. Health insurance premium deduction for self-employed individuals;
5. Retiree health accounts in pension plans under IRC §401(h) that provide for payment of benefits for sickness, accident, hospitalization, and medical expenses; and
6. Payments from voluntary employee beneficiary associations for life, sickness, accident, or other benefits.

Coverage and reimbursements under an employer-provided accident and health plan for employees and their dependents are **also excluded** from wages for withholding, FICA, and FUTA purposes.

1. PL No. 111-148 124 Stat. 119 (2010).
2. PL No. 111-152 124 Stat. 1029 (2010).
3. IRS Notice 2010-38, 2010-20 IRB 682.

These exclusions have been expanded to apply to benefits provided for adult children who are **under age 27** at the end of the tax year. In this context, "children" includes all of the following.

1. Children and stepchildren
2. Adopted children
3. Eligible foster children (as defined in IRC §152(f)(1)(C))

At first glance, it seems that Congress made a mistake by using the maximum age of 26 in the mandatory coverage provision and the cut-off age of 27 in the tax-exclusion provisions. However, this is because the age test is based on the yearend value, as the following example illustrates.

**Example 1.** The University of Illinois provides healthcare coverage for its employees and their spouses, dependents, and any employee's child who is under age 26. Venita is an employee of the university and her son, Clifford, is covered under her policy in 2011 until his 26th birthday, which occurs on September 21, 2011. Clifford does **not** qualify as a dependent for tax purposes.

Clifford is Venita's child within the meaning of IRC §152(f)(1). Accordingly, and because Clifford is under age 27 during the 2011 tax year, the healthcare coverage and reimbursements provided to him under the terms of the health plan are excludable from Venita's gross income until September 21, 2011, when Clifford attains age 26 and loses coverage under the terms of the plan.

Coverage provided for an adult child is **excludable** from gross income **regardless** of the adult child's:

- Dependency status,
- Income,
- Employment status,
- Eligibility for coverage under another plan, or
- Marital status.

## MEDICARE TAX ON INVESTMENT INCOME STARTING IN 2013[4]

For tax years beginning on or after January 1, 2013, individuals, certain trusts, and estates will be subject to an additional tax of 3.8% on **investment income** if their modified AGI (MAGI) exceeds certain thresholds. This tax is commonly referred to as the Medicare contribution tax.

**Observation.** The creation of this tax and its potential effects is the subject of much discussion among taxpayers. Many tax practitioners have already heard "Will I have to pay a 3.8% tax on the sale of my home?" Of course, the answer to that question is "It depends." See **Example 4.**

### MEDICARE CONTRIBUTION TAX ON INDIVIDUALS

#### Formula

For individuals, the Medicare contribution tax will apply to the **lesser** of:

1. Net investment income, or
2. The excess of MAGI over the threshold amount.

4. IRC §1411.

### Modified Adjusted Gross Income

Modified adjusted gross income (MAGI) for this purpose is calculated as follows.

| | |
|---|---|
| | Adjusted gross income |
| + | Foreign earned income (FEI) excluded from AGI |
| − | Deductions or exclusions disallowed with respect to FEI |
| | Modified adjusted gross income |

### Threshold Amounts

The threshold for the application of this tax is based on the taxpayer's filing status.

| | |
|---|---|
| Married filing jointly/surviving spouse | $250,000 |
| Married filing separately | 125,000 |
| Single/head of household | 200,000 |

### Net Investment Income

Net investment income is calculated as follows.

| | |
|---|---|
| | Total investment income |
| − | Allowed deductions allocable to the gross income or net gain |
| | Net investment income |



Investment income includes all of the following.

1. Interest
2. Dividends
3. Annuities
4. Royalties
5. Rents
6. Passive activity income from business sources (see IRC §469)
7. Income from a business trading in financial instruments or commodities (as defined in IRC §475(e)(2))
8. Net gains attributable to the disposition of property used in a passive activity or financial trading business
9. Income on investment of working capital (similar to the rule of IRC §469(e)(1)(B))
10. Realized capital gains attributable to the disposition of investment properties

Net investment income does **not** include any of the following.

1. Wages
2. SE income
3. Distributions from qualified retirement plans.
    a. Pension, profit-sharing, and stock bonus plans under IRC §401(a)
    b. Employee annuities under IRC §403(a)
    c. Employee annuities for employees of tax-exempt organizations under IRC §403(b)

d. Traditional IRAs under IRC §408

e. Roth IRAs under IRC §408A

f. Deferred compensation plans of state/local governments and tax-exempt organizations under IRC §457(b)

4. Income derived in the ordinary course of a trade or business, except as specifically included

5. Net gains from the disposition of assets used in a trade or business, except as specifically included

6. Tax-exempt interest and dividends

7. Net gains from dispositions of partnership and S corporation interests **to the extent** that such gains are attributable to the fair market value (FMV) of the assets immediately before the disposition of such interest

**Note.** See **www.irs.gov/businesses/small/article/0,,id=146845,00.html** for information on how to divide the net gain of item 7 into investment and non-investment income.

**Example 2.** Fritz and Cathy earn combined salaries of $300,000 per year in 2013. They have no other income. Therefore, Fritz and Cathy are **not** subject to the Medicare **contribution tax** because they have **no investment income.**

**Example 3.** Sandy is unmarried and files as a single person. Her 2013 income consists of wages, investment income, and gambling winnings. Her MAGI and Medicare contribution tax are calculated as follows.

| | Income | Investment Income Portion |
|---|---|---|
| Wages | $200,000 | $ 0 |
| Interest | 2,000 | 2,000 |
| Dividends | 6,000 | 6,000 |
| Gambling winnings | 20,000 | 0 |
| **Total** | **$228,000** | **$8,000** |

Sandy will pay **$304** in Medicare contribution tax for 2013, as calculated here.

| | | |
|---|---|---|
| Lesser of: | | |
| 1. Investment income | | $ 8,000 |
| 2. Income above the threshold: | | |
| MAGI | $228,000 | |
| Less: threshold for single filers | (200,000) | |
| Excess MAGI | $ 28,000 | 28,000 |
| The lesser amount is | | $ 8,000 |
| Multiplied by Medicare contribution tax rate | | × 3.8% |
| **Sandy's 2013 Medicare contribution tax** | | **$ 304** |

**Observations for Example 3.**

1. Gambling income is not specifically included or excluded from the definition of investment income in the Code section that establishes the Medicare contribution tax. However, the IRS does not consider gambling winnings as investment income.[5]

2. Gambling losses are generally not deductible from AGI. Even if Sandy lost $50,000 gambling in 2013, the calculation of her income above the threshold would not change from the one shown above.

5. IRS Pub. 550, *Investment Income and Expenses.*

**Example 4.** Glen and Patricia are married. They file a 2013 joint return. In 2013, they sell their principal residence, which they had owned and occupied for 20 years. Their net gain on the sale of the home is $800,000. Their 2013 income consists of the following.

| | Income | MAGI | Investment Income Portion |
|---|---|---|---|
| Wages | $ 300,000 | $300,000 | $ 0 |
| Interest | 10,000 | 10,000 | 10,000 |
| Taxable annuity distributions | | | |
| Source: direct taxpayer investment | 20,000 | 20,000 | 20,000 |
| Source: §403(b) annuity | 30,000 | 30,000 | 0 |
| Net gain on stock sale | 40,000 | 40,000 | 40,000 |
| Net gain from sale of principal residence | 800,000 | 800,000 | 800,000 |
| IRC §121 exclusion | 0 | (500,000) | (500,000) |
| Total | $1,200,000 | $700,000 | $370,000 |

Glen and Patricia will pay **$14,060** in Medicare contribution tax for 2013, as calculated here.

| | | |
|---|---|---|
| Lesser of: | | |
| 1. Investment income | | $370,000 |
| 2. Income above the threshold: | | |
| MAGI | $700,000 | |
| Less: threshold for joint filers | (250,000) | |
| Excess MAGI | $450,000 | 450,000 |
| The lesser amount is | | $370,000 |
| Multiplied by Medicare contribution tax rate | | × 3.8% |
| **2013 Medicare contribution tax** | | **$ 14,060** |

**Observation 1.** Only a few taxpayers will pay the Medicare contribution tax on the sale of their principal residence. This is because the tax applies only to taxpayers:

1. Who have a gain on the sale,
2. Whose income is above the Medicare contribution tax thresholds, **and**
3. Who do not qualify for the IRC §121 exclusion for the sale of a principal residence **or** whose gain on the sale of their principal residence exceeds the $250,000/$500,000 maximum IRC §121 exclusion.

**Observation 2.** Practitioners must be careful to distinguish direct taxpayer-investment annuity distributions from qualified-plan annuity distributions for clients with incomes above the thresholds. In Glen and Patricia's example, including the exempt $30,000 employment annuity in investment income would have cost them $1,140 more in Medicare contribution tax.

**Observation 3.** Glen and Patricia realized an $800,000 gain on the sale of their principal residence. If their gain had been less than the maximum $500,000 IRC §121 exclusion amount, they would have paid no income taxes and no Medicare contribution taxes on the sale. Their investment income without the gain would have been $70,000.

## Exclusions

The Medicare contribution tax does not apply to nonresident aliens.

## MEDICARE CONTRIBUTION TAX FOR TRUSTS AND ESTATES

### Formula

For trusts and estates, the Medicare contribution tax applies to the **lesser** of:

1. Undistributed net investment income, or
2. The excess of AGI over the dollar amount at which the highest tax bracket for estates and trusts begins for the taxable year.

### Exclusions

The Medicare contribution tax does not apply to trusts organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; to foster national or international amateur sports competition; or for the prevention of cruelty to children or animals.

**Planning Pointer.** Assuming the law remains unchanged, the Medicare contribution tax represents challenging planning issues for practitioners as to the timing and nature of when to recognize gains or losses. These discussions with your clients should begin as soon as spring of 2012.

# FOREIGN ASSET DISCLOSURE REQUIREMENTS[6]

In an effort to combat tax evasion by U.S. taxpayers that hold investments in offshore accounts, Congress passed the Foreign Account Tax Compliance Act (FATCA) as part of the Hiring Incentives to Restore Employment (HIRE) Act.[7] Under this act, taxpayers holding financial assets outside the United States must report them as part of their income tax return. **The reporting requirement goes into effect for tax years beginning on or after January 1, 2011.** Taxpayers failing to comply with the reporting requirements are subject to penalties.

In addition, FATCA will require **foreign financial institutions** to report certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. **This requirement applies to payments made by foreign financial institutions to covered accounts on or after January 1, 2013.**

## REPORTING BY U.S. PERSONS

The reporting requirement is triggered when a U.S. person holds foreign financial assets with a **combined value at any point during the relevant tax year exceeding $50,000.** The law also applies to any domestic entities that are used to hold specified foreign financial assets, **directly or indirectly.**[8]

The required information is reported by taxpayers on Form 8938, *Statement of Specified Foreign Financial Assets*, which is a new form specifically designed for this purpose.

**Note.** Treasury Department Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR), is another form that must be filed. It is required when the aggregate value of foreign accounts exceeds $10,000. The new filing requirement does **not** change this obligation. Because the FBAR is not considered "return information," its contents may be distributed to law enforcement agencies. FBAR requirements are covered later in this chapter, in the section "Offshore Account Tax Compliance."

---

6. *Summary of Key FATCA Provisions.* (Feb. 25, 2011). [www.irs.gov/businesses/corporations/article/0,,id=236664,00.html] Accessed on May 28, 2011.
7. Ibid.
8. IRC §6038D(f).

The initial penalty for failing to disclose foreign financial assets is $10,000. Additional penalties of up to $40,000 could be assessed for continued failure to disclose after the IRS notifies the taxpayer of the requirement. Further, taxpayers may be charged an additional substantial underpayment penalty of 40% of the understated tax attributable to undisclosed foreign financial assets.

### Specified Foreign Financial Assets

Specified foreign financial assets include the following accounts.

1. Depository or custodial accounts at foreign financial institutions
2. Assets **not** held at a financial institution that include:
   a. Stocks or securities issued by foreign persons
   b. Any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person
   c. Any interest in a foreign entity

### Form 8938, *Statement of Specified Foreign Financial Assets*

The information reported on Form 8938 includes identifying information for each asset and its maximum value during the taxable year. Identifying information for an **account with a foreign financial institution (FFI)** includes the name and address of the institution and the account number. **For a stock or security**, it includes the name and address of the issuer, and any other information necessary to identify the stock or security and its terms of issuance. For **all other** instruments, contracts, or interests in foreign entities, it includes any information necessary to identify the nature of the investment and the names and addresses of all foreign issuers and counterparties.



**An individual is not required to disclose interests that are held in a custodial account with a U.S. financial institution.** This is a significant exception for taxpayers holding mutual funds that invest in foreign companies.

Draft Form 8938 was released by the Treasury Department. The following is the most recent draft form available at the time this chapter was written.

**Note.** IRS Notice 2011-55, published June 26, 2011, suspends the Form 8938 filing requirement for individuals for the 2011 taxation year. The IRS indicates in this notice that the new Form 8938 may not be released before the deadline for 2011 income tax returns. Individuals must attach the 2011 and 2012 Forms 8938 with their 2012 tax return.

Form **8938** (November 2011)
Department of the Treasury
Internal Revenue Service

# Statement of Specified Foreign Financial Assets

▶ See separate instructions ▶ Attach to your tax return

OMB No. 1545-2195
Attachment Sequence No. **175**

**If you have attached additional sheets, check here** ☐

Name(s) shown on return | Identifying number

Number, street, and room or suite no. (if a P.O. box, see instructions)

City or town, province or state, and country (including postal code)

For tax year beginning , 20 , and ending , 20

**Note.** All information must be in English. Show all amounts in U.S. dollars. Show currency conversion rates in Part I, line 6(2), or Part II, line 6(2).

Type of filer
**a** Specified individual **(1)** ☐ Married filing a joint return **(2)** ☐ Other individual
**b** Specified domestic entity **(1)** ☐ Partnership **(2)** ☐ Corporation **(3)** ☐ Trust **(4)** ☐ Estate

Check this box if this is an original, amended, or supplemental Form 8938 for attachment to a previously filed return . . . . . . ☐



## Part I Foreign Deposit and Custodial Accounts (see instructions)

If you have more than one account to report, attach a continuation sheet with the same information for each additional account (see instructions).

**1** Type of account ☐ Deposit ☐ Custodial
**2** Account number or other designation

**3** Check all that apply **a** ☐ Account opened during tax year **b** ☐ Account closed during tax year
**c** ☐ Account jointly owned with spouse **d** ☐ No tax item reported in Part III with respect to this asset

**4** Maximum value of account during tax year . . . . . . . . . . . . . . . . . . . . . . $

**5** Did you use a foreign currency exchange rate to convert the value of the account into U.S. dollars? . . . ☐ Yes ☐ No

**6** If you answered "Yes" to line 5, complete all that apply.

| (1) Foreign currency in which account is maintained | (2) Foreign currency exchange rate used to convert to U.S. dollars | (3) Source of exchange rate used if not from U.S. Treasury Financial Management Service |
|---|---|---|
| | | |

**7** Name of financial institution in which account is maintained

**8** Mailing address of financial institution in which account is maintained. Number, street, and room or suite no.

**9** City or town, province or state, and country (including postal code)

## Part II Other Foreign Assets (see instructions)

**Note.** *If you reported specified foreign financial assets on Forms 3520, 3520-A, 5471, 8621, or 8865, you do not have to include the assets on Form 8938. You must complete Part IV. See instructions.*

If you have more than one asset to report, attach a continuation sheet with the same information for each additional asset (see instructions).

**1** Description of asset
**2** Identifying number or other designation

**3** Complete all that apply
**a** Date asset acquired during tax year, if applicable . . . . . . . . . . . . . . . . . . . .
**b** Date asset disposed of during tax year, if applicable . . . . . . . . . . . . . . . . . . .
**c** ☐ Check if asset jointly owned with spouse **d** ☐ Check if no tax item reported in Part III with respect to this asset

**4** Maximum value of asset during tax year (check box that applies)
**a** ☐ $0 - $50,000 **b** ☐ $50,001 - $100,000 **c** ☐ $100,001 - $150,000 **d** ☐ $150,001 - $200,000
**e** If more than $200,000, list value . . . . . . . . . . . . . . . . . . . . . . . . $

**5** Did you use a foreign currency exchange rate to convert the value of the asset into U.S. dollars? . . . ☐ Yes ☐ No

**For Paperwork Reduction Act Notice, see the separate instructions.** Cat. No. 37753A Form **8938** (11-2011)

**Part II Other Foreign Assets** *(continued)*

6 If you answered "Yes" to line 5, complete all that apply.

| (1) Foreign currency in which asset is denominated | (2) Foreign currency exchange rate used to convert to U.S. dollars | (3) Source of exchange rate used if not from U.S. Treasury Financial Management Service |
|---|---|---|
| | | |

7 If asset reported in Part II, line 1, is stock of a foreign entity or an interest in a foreign entity, report the following information.

a Name of foreign entity

b Type of foreign entity (1) ☐ Partnership (2) ☐ Corporation (3) ☐ Trust (4) ☐ Estate

c ☐ Check if foreign entity is a PFIC

d Mailing address of foreign entity. Number, street, and room or suite no.

e City or town, province or state, and country (including postal code)

8 If asset reported in Part II, line 1, is not stock of a foreign entity or an interest in a foreign entity, enter the following information for the asset.

**Note.** If this asset has more than one issuer or counterparty, attach a continuation sheet with the same information for each additional issuer or counterparty (see instructions).

a Name of issuer or counterparty

Check if information is for ☐ Issuer ☐ Counterparty

b Type of issuer or counterparty

(1) ☐ Individual (2) ☐ Partnership (3) ☐ Corporation (4) ☐ Trust (5) ☐ Estate

c Check if issuer or counterparty is a ☐ U.S. person ☐ Foreign person

d Mailing address of issuer or counterparty. Number, street, and room or suite no.

e City or town, province or state, and country (including postal code)





**Part III Summary of Tax Items Attributable to Specified Foreign Financial Assets** (see instructions)

| Asset Category | Tax item | Amount reported on form or schedule | Where reported: Form and line | Where reported: Schedule and line |
|---|---|---|---|---|
| I. Foreign Deposit and Custodial Accounts | a Interest | $ | | |
| | b Dividends | $ | | |
| | c Royalties | $ | | |
| | d Other income | $ | | |
| | e Gains (losses) | $ | | |
| | f Deductions | $ | | |
| | g Credits | $ | | |
| II. Other Foreign Assets | a Interest | $ | | |
| | b Dividends | $ | | |
| | c Royalties | $ | | |
| | d Other income | $ | | |
| | e Gains (losses) | $ | | |
| | f Deductions | $ | | |
| | g Credits | $ | | |

**Part IV Excepted Specified Foreign Financial Assets** (see instructions)

If you reported specified foreign financial assets on the following forms, check the appropriate box(es). Indicate number of forms filed. You do not need to include these assets on Form 8938 for the tax year.

☐ 3520 Number of forms ________ ☐ 3520-A Number of forms ________ ☐ 5471 Number of forms ________

☐ 8621 Number of forms ________ ☐ 8865 Number of forms ________

### Penalties

FATCA created two new penalties related to foreign holdings. The first penalty relates to failure to disclose the foreign financial investments and the second relates to understating the taxes on the income from the undisclosed investments.

**Disclosure Penalties.** Individuals who fail to make the required disclosures for the tax year are subject to a penalty of $10,000. Additional penalties apply if the IRS notifies the individual of the failure and the individual does not provide the information within 90 days of the notice. The penalty increases by $10,000 for each 30-day period (or a fraction thereof), up to a maximum penalty of $50,000 per year.

**Example 5.** Alis has a bank account in Switzerland. During 2012, the highest value of the account is $75,000. Alis refuses to file Form 8938 with her 2012 return. On June 30, 2014, the IRS notifies her that she must file Form 8938 within 90 days or face additional penalties. After consultation with her tax advisor, her priest, and her psychic, she finally files the form 95 days later on October 3, 2014. Alis incurs a penalty of $20,000.

| | |
|---|---|
| Initial penalty | $10,000 |
| Plus: penalty for one 30-day period | 10,000 |
| Total penalty | $20,000 |

**Example 6.** Larry has a bank account in China. During 2012, the highest value of the account is $200,000. He failed to file Form 8938 with his 2012 return. On June 30, 2014, the IRS notifies him that he must file Form 8938 within 90 days or face additional penalties. After much delay and consultation with his attorney, he finally files the form 365 days later on June 30, 2015. Larry incurs a penalty of $50,000.

| | | |
|---|---|---|
| Initial penalty | $10,000 | 90 days |
| Plus: additional penalty | 40,000 | 120 days |
| **Total penalty** | **$50,000** | **210 days** |

Larry does not incur any penalty after the 210 days have passed because he has already reached the maximum penalty amount.

The IRS may grant a waiver of the penalty for an individual who can show that the failure was due to **reasonable cause** and not willful neglect. Foreign law prohibitions against disclosure of the required information are not sufficient to establish reasonable cause.

If the IRS determines that the individual has an interest in one or more foreign financial assets but the individual does not provide enough information to determine the aggregate value, the aggregate value of such identified foreign financial assets are presumed to exceed $50,000 for purposes of assessing the penalty.

**Understatement Penalties.**[9] FATCA added a new accuracy-related penalty to the Code. This penalty is 40% of the tax resulting from any understatement attributable to income from **undisclosed** foreign financial assets. This penalty applies to disclosures required under the following provisions of the Code.

1. IRC §6038 — for foreign corporations and partnerships controlled by the taxpayer
2. IRC §6038A — for domestic corporations with more than 25% foreign ownership
3. IRC §6038D — for individuals owning specified foreign financial assets described in FATCA
4. IRC §6046A — for changes in ownership of foreign partnerships
5. IRC §6048 — for transactions involving certain foreign trusts

9. IRC §6662(j).

A taxpayer who fails to comply with the self-reporting requirements for a foreign financial asset may incur a 40% penalty on the related understated tax. This is **double** the otherwise applicable penalty for substantial understatements or negligence.

Exceptions to the penalty may be allowed if the taxpayer can show reasonable cause and that they acted in good faith.[10] Reasonable cause and good faith are determined on a case-by-case basis subject to the facts and circumstances in each situation.[11]

### Modification of Statute of Limitations

A new **6-year** limitations period for assessment of tax on understatements of income attributable to foreign financial assets was created by FATCA. The extended period applies if:

- There is an omission of gross income in excess of $5,000, **and**
- The omitted gross income is attributable to a foreign financial asset.

This extended period applies even if the individual was **not** required to file Form 8938 for the tax year in question.

**Example 7.** On January 3, 2011, DyAnne purchases a direct ownership interest in Deutchland Schatz, a corporation based in Germany that was started by a college friend. She pays $10,000 for her share of the start-up company. On December 1, 2011, the ownership share reaches its highest value for the year and she decides to sell it for $32,000. This is her only foreign financial asset, and its value never exceeded $50,000 during 2011. DyAnne's 2011 short-term gain on the sale is $22,000:

| | |
|---|---|
| Gross sales price | $32,000 |
| Less: cost basis | (10,000) |
| **Short-term capital gain** | **$22,000** |

DyAnne does not receive a Form 1099-B reporting the sale, and she forgets to include the sale on her 2011 return, which she files in April 2012. She is **not required** to file **Form 8938,** because the value of her foreign financial assets **does not exceed $50,000 during 2011.**

The usual 3-year statute of limitations expires on April 15, 2015. However, because the omitted gain is more than $5,000 and it relates to a foreign financial asset, the IRS has until **April 15, 2018** to assess the tax on the unreported income.

FATCA also **suspends the limitations period** for assessment if a taxpayer fails to disclose the required information related to foreign financial assets or passive foreign investment corporations (PFICs). The limitations period does not begin until the information required by those provisions is furnished to the IRS.

**Example 8.** Use the same facts as **Example 7,** except the value of the stock reached $60,000 during 2011 before she sold it for $32,000. DyAnne is **required to file Form 8938** with her 2012 return because the value of her investment during 2011 exceeded $50,000.

In 2013, DyAnne tells the story of her adventures in foreign corporation ownership to another college friend who is a CPA. The CPA asks if DyAnne filed Form 8938 with her 2012 return. He explains the requirements and offers to file the form for her. He does not review her 2011 return and, therefore, does not know that she forgot to report the $22,000 gain.

DyAnne files Form 8938 on August 22, 2013. The IRS has until August 22, 2019 to assess the tax on the 2011 unreported $22,000 short-term capital gain. See the note box in the preceding section for more details regarding when Form 8938 must be filed.

10. IRC §6664(c).

11. Treas. Reg. §1.6664-4(b).

The extended statute of limitations provision also applies to returns that were still open under the usual 3-year statute at the time of the March 18, 2010, enactment. Therefore, in general, the extended statute of limitations may be applied to returns going as far back as tax year 2006.

### Passive Foreign Investment Companies (PFICs)

Prior to FATCA, taxpayers with interests in PFICs were required to file Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund*, for each tax year in which certain triggering events occurred.[12] FATCA added a provision[13] allowing the IRS to require taxpayers who are shareholders in PFICs to report related information annually.

## REPORTING BY FOREIGN FINANCIAL INSTITUTIONS (FFIs)

For transactions occurring in **2013 and later**, FATCA also requires FFIs to disclose certain information about financial accounts held by U.S. taxpayers. These provisions also apply to accounts held by foreign entities in which U.S. taxpayers hold a substantial interest — for example, foreign trusts with U.S. beneficiaries.

To properly comply, FFIs must enter into a special agreement with the IRS during 2012. Under this agreement, participating FFIs are required to:

1. Undertake certain identification and due diligence procedures with respect to accountholders;
2. Report annually on accountholders who are U.S. persons or foreign entities with substantial U.S. ownership; and
3. Withhold and submit 30% of any payments of U.S. source income, as well as gross proceeds from the sale of securities that generate U.S. source income, made to:
    a. Nonparticipating FFIs,
    b. Individual accountholders failing to provide sufficient information to determine whether or not they are a U.S. person, or
    c. Foreign entity accountholders failing to provide sufficient information about the identity of its substantial U.S. owners.

Failure to disclose this information to the Treasury Department results in a flat 30% tax-withholding rate on U.S. source payments made to the nondisclosing FFI. FATCA substantially broadens the Treasury Department's powers to obtain information regarding hidden accounts and assets.

> **Observation.** Some foreign countries such as Japan, Australia, and the Cayman Islands are seeking blanket exemption from these requirements for their financial institutions due to the burden of compliance.[14]

## OFFSHORE ACCOUNT TAX COMPLIANCE

U.S. citizens and resident aliens are generally subject to the same tax rules and must report worldwide income. This requires reporting all capital gains, interest, dividends, rental income, and other forms of investment income. This includes income attributable to investments held outside of the United States. In addition, holding foreign investments places additional compliance requirements on the taxpayer.

---

12. IRC §1291(e) by reference to IRC §1246(f).

13. IRC §1298(f).

14. *New Form 8938 — Son of FuBAR Is Here.* Nov. 8, 2010. Hodgen Law Group PC. [http://hodgen.com/new-form-8938-son-of-fubar-is-here] Accessed on May 29, 2011.

While reporting income from foreign sources is an IRS concern, disclosure of the foreign accounts and assets is also a requirement for many taxpayers. This is true even if the foreign accounts or assets do not generate any income during the taxable year.

### Form TD F 90-22.1 (FBAR)

Taxpayers must disclose a financial interest or signature authority over **foreign financial accounts** that exceed $10,000 in aggregate at any time during the year. Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts,* (FBAR) is used for this purpose. The form is filed each year in which the taxpayer has this type of financial interest or signature authority. A financial account is considered foreign if it is located outside the United States.

> **Note.** An account physically located outside the United States but maintained at a branch of a U.S. bank is considered a **foreign** account. However, an account maintained with a bank on a foreign U.S. military installation is not considered a foreign account.

"Financial account" is very broadly defined. Items that constitute a financial account include the following.

- A savings or checking account
- A CD or time deposit
- A securities or brokerage account
- A commodity futures or options account
- An insurance or annuity policy with a cash value
- An account with a mutual or segregated fund holding

7

> **Note.** The Financial Crimes Enforcement Network, a branch of the Treasury Department, issued final regulations[15] on the reporting of foreign financial accounts that became effective March 28, 2011. A revised Form TD F 90-22.1 was released in March 2011.

The owner or beneficiary of an IRA, §§401(a), 403(a), or 403(b) account is not required to file this form to disclose a foreign investment held within their IRA account. Certain trust beneficiaries of foreign trusts are exempt from the filing requirements.[16] Moreover, when a taxpayer duly files an FBAR covering accounts jointly owned with a spouse, the spouse can sign the FBAR and no second FBAR is required for those accounts.

The details on each foreign account that must be disclosed include the following.

- The type of account
- The location of the account
- The balance within each account
- The financial institution with which the account is placed

> **Observation**. Authority and control over offshore accounts has become an area of substantially heightened IRS interest and scrutiny. It is highly prudent to ensure full compliance is met in this area to avoid aggressive enforcement of civil and criminal penalties resulting from failure to disclose.

15. These regulations are codified at 31 CFR §1010.350.

16. Other exempted taxpayers and exempted types of accounts may be found in 31 CFR §1010.350.

**An FBAR is not filed with the taxpayer's annual tax return. It is filed separately with the Detroit, Michigan office of the Department of the Treasury.** The form is due by June 30 of the year following the year that the disclosure is required. This due date bears no relationship to a tax return due date. Extension of the tax return due date does not extend the normal June 30 due date for an FBAR.

New FBAR regulations were released and are effective March 28, 2011. Among other changes, these new regulations expand IRS enforcement powers with disclosure of foreign accounts and assets, update the FBAR form to be filed each year, and increase the criminal penalties for failure to file this form as required.

The penalties for not filing the FBAR form or for filing a false form are:

- **Civil penalty** of up to $10,000, and
- **Criminal penalty** of up to $500,000 and/or five years' imprisonment.

The civil penalty can be waived if the income from the offshore assets was reported and there was reasonable cause for failure to file the form.

For several months leading up to the new regulations effective March 28, 2011, the IRS gradually increased its investigatory and enforcement powers and efforts in the area of offshore account disclosure.

The following cases are a small sampling of successful IRS efforts in this area.

- **June 27, 2011 —** Kenneth Heller of New York, New York, pleaded guilty to income tax evasion. Heller admitted to hiding more than $26.4 million in a bank account at UBS AG and agreed to pay a civil penalty of over $9.8 million.
- **June 20, 2011 —** Sean and Nadia Roberts of Tehachapi, California, pleaded guilty to filing a false tax return related to an undisclosed Swiss bank account at UBS AG.
- **May 24, 2011 —** Harry Abrahamsen of Oradell, New Jersey, was sentenced to three years' probation, including 12 months of home confinement with electronic monitoring, and ordered to pay $600,000 in restitution to the IRS. He also agreed to pay a civil penalty in excess of $300,000. In April 2010, Mr. Abrahamsen pleaded guilty to failure to file an FBAR report and admitted that he concealed over $1 million in Swiss bank accounts.
- **March 14, 2011** — Jeffrey Chatfield of San Diego, California, was sentenced to three years' probation and ordered to pay more than $96,000 to resolve his civil liability with the IRS for failing to file the required FBARs. Chatfield pleaded guilty on November 18, 2010, to filing a false tax return in which he failed to report a UBS account containing $900,000. Between 2000 and 2008, Chatfield transferred the $900,000 through several offshore accounts of nominee entities.
- **February 18, 2009** — UBS AG, Switzerland's largest bank, entered into a deferred prosecution agreement on charges of conspiring to defraud the United States by impeding the IRS.

### Recordkeeping Requirement

Taxpayers who file an FBAR are required to maintain records regarding the details on each foreign account for a period of five years from the June 30 deadline. The maximum balance attained in each foreign account for the year must also be documented.

**Note.** A taxpayer who is an employee or officer and has signature authority over an employer's foreign account is subject to the FBAR filing requirements but not the recordkeeping requirement.

### Foreign Account Tax Compliance

Proposed FATCA regulations are expected before the end of 2011. Final regulations are expected during 2012. The provisions of FATCA will be fully effective January 1, 2013.

> **Note.** IRS Notice 2011-55, published July 18, 2011, also suspends some other 2011 FATCA filing requirements.

### Offshore Voluntary Compliance Initiative

Similar to previous amnesty programs, the IRS announced a new 2011 offshore voluntary disclosure initiative. This new program was announced on February 8, 2011. This program is for taxpayers who evaded U.S. taxes by failing to disclose their offshore accounts. These taxpayers can now voluntarily disclose such accounts. Under this initiative, the taxpayer must provide full offshore disclosure for the 2003 through 2010 tax years. Any necessary amendments to tax returns for these years, along with other related paperwork, were due August 31, 2011.

The initiative required participating taxpayers to:

- Pay all taxes in arrears plus interest,
- Pay an accuracy-related penalty of 20% of the amount of tax arrears, and
- Pay an additional penalty of 25% of the amount in the foreign accounts (based on the highest aggregate balance in the accounts within the 2003 through 2010 period).



The IRS emphasizes its increasing success with investigating and finding cases of offshore nondisclosure. In addition, the IRS stresses that while the penalties under this initiative are steep, the taxpayer avoids incarceration.[17]

## SCHEDULE B AND CONTROL OVER FOREIGN ACCOUNTS

Schedule B is required if over $1,500 of taxable interest or ordinary dividends are received each year. This includes the amount of foreign interest and dividends expressed in U.S. dollars. Such foreign interest or dividends are reported on Schedule B.

However, Schedule B is **also** required if the taxpayer:

- Had a financial interest in or signature authority over a financial account in a foreign country,
- Received a distribution from a foreign trust, or
- Was a grantor or transferor of a foreign trust.

The above Schedule B filing requirements apply even if the $1,500 interest or dividend threshold is not met.[18] Specifically, Part III of Schedule B provides the IRS with disclosure on the control or authority over foreign accounts. Part III is shown below.

| | | | Yes | No |
|---|---|---|---|---|
| **Part III Foreign Accounts and Trusts** (See instructions on back.) | | You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust. | | |
| | 7a | At any time during 2011, did you have a financial interest in or signature authority (or other authority that is comparable to signature authority) over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See instructions on back for exceptions and filing requirements for Form TD F 90-22.1 | | |
| | b | If "Yes," enter the name of the foreign country ▶ | | |
| | 8 | During 2011, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back | | |

**For Paperwork Reduction Act Notice, see your tax return instructions.** Cat. No. 17146N **Schedule B (Form 1040A or 1040) 2011**

17. Further details about the offshore voluntary disclosure initiative can be found on the IRS website.

18. See Schedule B General Instructions.

## LIFE INSURANCE POLICY DISBURSEMENTS

A whole life policy accumulates cash value during the time the policy is in force. Each premium payment is applied partially to the cost of insurance and partially to a savings account embedded in the policy. Earnings on the savings account are not taxable unless the funds are withdrawn prior to death. The accumulated savings constitutes the **cash value** of the policy. The **surrender value** is the cash value less any surrender fees applicable under the contract.

Whole life insurance contracts are often used as investment vehicles in retirement planning. As such, the policyholder intends to withdraw all or some of the cash value from the contract prior to death. In addition, many people use the cash values of whole life policies as cash reserves for emergencies.

The tax consequences of accessing funds from a life insurance policy vary depending on the method used. There are several ways for a policyholder to access the value of a life insurance policy, including:

- Borrowing from a contract that has a cash value,
- Surrendering the policy for the cash value, and
- Selling the policy to an unrelated party.

### BORROWING

The cash value of a life insurance policy may be borrowed or used as collateral for a loan subject to restrictions in the contract. As long as the contract stays in force, this is a nontaxable event. However, if the policy lapses, the loan balance is considered proceeds received upon surrender. These "proceeds" are then taxed under the rules described in the next section.

**Caution.** Life insurance contracts which have not been in force for more than seven years are vulnerable to classification as modified endowment contracts (MEC) under IRC §7702A(b). If the policy is classified as an MEC, borrowed amounts are considered distributions from an annuity. Distributions from an MEC are usually taxable first as income, then as return of investment.

Furthermore, MEC distributions may be subject to the 10% early-withdrawal penalty. Prior to advising clients to borrow against or withdraw their life insurance cash values, tax practitioners should consult with the insurance company to ensure that the payment will not result in the contract being classified as an MEC.

### SURRENDERING[19]

The owner of a whole life insurance contract is entitled to receive the cash value, less surrender charges, upon cancellation of the contract. **An amount received under a complete surrender, redemption, or maturity of a life insurance contract is taxable only to the extent it exceeds the investment in the contract.** The basis in the contract is calculated as follows.

| | |
|---|---|
| | Total premiums or other consideration paid for the contract before the surrender date |
| − | Aggregate amounts previously received and excluded from gross income |
| | Basis in contract |

If the distribution exceeds the taxpayer's investment in the contract, the taxable income is characterized as **ordinary income** and taxed at the taxpayer's ordinary income tax rate. **The insurance company is responsible for making this calculation, and it should issue the taxpayer a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, showing the total distribution and the taxable portion.**

If the distribution is **less** than the net premiums, the taxpayer is **not allowed to claim a loss** on the cancellation of the policy. In effect, the loss is the net cost of the benefit of being insured during the time the policy was in place.

19. Rev. Rul. 2009-13, 2009-21 IRB 1029.

**Example 9.** In 2011, Daniel surrenders a whole life insurance policy for $2,000. He had not previously received any policy loans or nontaxable policy dividends. Prior to the surrender date, he had paid a total of $5,000 in policy premiums.

Daniel incurs a $3,000 loss from his surrender of the policy. His total $5,000 investment exceeds the $2,000 he realized from terminating the contract. He will **not** receive a Form 1099-R from his insurance company. The $3,000 loss is nondeductible.

**Example 10.** In 2011, Trisha surrenders a whole life insurance policy for $20,000. Prior to the surrender date she had paid a total of $16,000 in policy premiums. However, in 2009, she received a $10,000 policy loan that was excluded from her income.

Trisha has a $14,000 gain from the surrender of the policy. This gain is taxed as **ordinary income.** The gain is calculated as follows:

| | |
|---|---|
| Basis in contract: | |
| Total premiums paid to date | $16,000 |
| Less: amount previously withdrawn and excluded from income | (10,000) |
| Total basis in contract | $ 6,000 |
| Gain on surrender: | |
| Total proceeds received upon surrender | $20,000 |
| Less: basis in contract | (6,000) |
| **Total gain from cancellation** | **$14,000** |



She receives the following Form 1099-R from her insurance company.

☐ CORRECTED (if checked)

| | | | | |
|---|---|---|---|---|
| PAYER'S name, street address, city, state, and ZIP code<br>**INSURANCE COMPANY** | | 1 Gross distribution<br>$ **20,000.00**<br>2a Taxable amount<br>$ **14,000.00** | OMB No. 1545-0119<br>2011<br>Form **1099-R** | **Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.** |
| | | 2b Taxable amount not determined ☐ | Total distribution ☒ | **Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.** |
| PAYER'S federal identification number<br>**13-1313313** | RECIPIENT'S identification number<br>**333-13-1313** | 3 Capital gain (included in box 2a)<br>$ | 4 Federal income tax withheld<br>$ | |
| RECIPIENT'S name<br>**TRISHA** | | 5 Employee contributions /Designated Roth contributions or insurance premiums<br>$ **16,000.00** | 6 Net unrealized appreciation in employer's securities<br>$ | |
| Street address (including apt. no.) | | 7 Distribution code(s) **7** — IRA/ SEP/ SIMPLE ☐ | 8 Other<br>$ % | This information is being furnished to the Internal Revenue Service. |
| City, state, and ZIP code | | 9a Your percentage of total distribution % | 9b Total employee contributions<br>$ | |
| 10 Amount allocable to IRR within 5 years<br>$ | 11 1st year of desig. Roth contrib. | 12 State tax withheld<br>$<br>$ | 13 State/Payer's state no. | 14 State distribution<br>$<br>$ |
| Account number (see instructions) | | 15 Local tax withheld<br>$<br>$ | 16 Name of locality | 17 Local distribution<br>$<br>$ |

Form **1099-R** Department of the Treasury - Internal Revenue Service

**Caution.** The tax treatment of this cancellation is different if the contract falls under the MEC classification. See IRC §72(e)(4) and the related regulations for more information.

## SELLING THE POLICY[20]

A taxpayer may sell a life insurance policy in order to raise funds. There are buyers for these types of policies. The IRS and the courts agree that a life insurance contract has both an **investment** aspect and an **insurance** aspect. Accordingly, in a sales transaction, as opposed to a surrender of the contract, the taxpayer's basis in the policy is adjusted for the cost of insurance protection.

> **Note.** A policyholder who has a terminal illness may sell the life insurance policy in order to fund medical care. This sale is called a **viatical settlement** and any gain on the sale is nontaxable.

The IRS has clarified the tax treatment for two types of sales regarding insurance policies. In the first situation, the policy has a cash value and in the second, it does not.

### Selling a Policy That Has Cash Value

The sale of a policy that has cash value involves selling both the current balance in the embedded savings account and the future value of the life insurance payout. The amount of the gain that represents the inside buildup is taxed as ordinary income and the balance is taxed as capital gain income.

**Example 11.** Dale is the policyholder of a life insurance contract on his life, which he purchased in 1993. In 2011, he sells the policy to an unrelated person for $10,000.

The following information is used to calculate his taxable gain.

| | | |
|---|---|---|
| Sales price | | $10,000 |
| Less: adjusted basis in policy | | |
| Premiums paid during life of policy | $6,300 | |
| Less: cost of insurance | (3,600) | |
| Adjusted basis in policy | $2,700 | (2,700) |
| **Total gain on sale** | | **$ 7,300** |

Dale's gain on the sale has two components. The calculation of the portion taxed as ordinary income is shown here.

| | |
|---|---|
| Cash value of policy | $7,000 |
| Less: total premiums paid | (6,300) |
| **Ordinary income portion** | **$700** |

The **capital gain component** of his gain is the **difference** between the total gain and the portion taxed as ordinary income.

| | |
|---|---|
| Total gain | $7,300 |
| Less: ordinary income portion | (700) |
| **Long-term capital gain** | **$6,600** |

> **Caution.** The tax treatment of this sale is different if the contract falls under the MEC classification. See IRC §72(e)(4) and the related regulations for more information.

20. Ibid.

### Selling a Policy That Has No Cash Value

**Term life policies, as opposed to whole life policies, do not accumulate cash value.** The premiums are typically much less than those for whole life policies because none of the premiums are allocated to redemption values. Therefore, when a term life policy is sold, no portion of the gain is attributable to a current asset, and there is no ordinary income to report. The resulting gain is reported as a capital gain.

The adjusted basis in a term life insurance contract is equal to the total premiums paid under the contract, less charges for provision of insurance prior to the sale. **Absent other proof, the cost of the insurance is presumed to equal the premiums paid for the period that coverage was provided to the policyholder.**

**Example 12.** Theresa pays a monthly premium for her term life insurance policy. When she sells the policy, there are 15 days of coverage remaining. Her basis in the policy is equal to the cost of insurance coverage for those 15 days.

**Example 13.** Denise is the owner of a term life insurance policy, which she first purchased in 2002. She has paid $20 per month for coverage for exactly nine years and two months; a total of $2,200 ($20 × 110 months). In 2011, she sells the policy to an unrelated person for $10,000. At the time of the sale, there is exactly a half month's worth of coverage remaining from the last payment she made.

Denise's gain from the contract sale is calculated here.

| | | |
|---|---|---|
| Sales price | | $10,000 |
| Less: adjusted basis in policy | | |
| Premiums paid during life of policy | $2,200 | |
| Less: cost of insurance | (2,190) | |
| Adjusted basis in policy | $ 10 | (10) |
| **Total gain on sale** | | **$ 9,990** |

**Observation.** Because the policy in **Example 13** does not build cash value, the policy is not subject to the MEC trap.

## HEALTH SAVINGS ACCOUNT (HSA) UPDATE

Health reimbursement arrangements (HRAs) and health savings accounts (HSAs)[21] allow taxpayers a tax-advantaged way to fund their medical expenses and save for future expenses. HSA accounts may be established by any individual or family that also has a coordinating high-deductible health plan (HDHP). Often, HSA-HDHP combinations are funded by employers as part of their efforts to control the cost of providing healthcare benefits to their employees.

Any distributions used for medical care are tax-free. Distributions from HSAs or HRAs that are not used for medical expenses are subject to income tax and subject to a **20%**[22] early-withdrawal penalty if taken before the owner reaches age 65, becomes disabled, or dies.

**Note.** Prior to 2011, the penalty was 10%. The penalty was increased to 20% as part of the provisions of the PPACA (IRC §223).

21. IRC §223.

22. IRC §223(f)(4)(A).

## EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI) STUDY[23]

HRAs were introduced in 2001. HSAs paired with HDHPs were first offered in 2004. Since then, HSAs and HDHPs have become increasingly popular. In 2010, the number of HRA and HSA accounts more than quadrupled from 2006 levels. In addition, in 2010 the total amount held in these types of accounts was nearly 10 times the amount held in 2006.

| Year | Number of Accounts | Total Account Balances |
|---|---|---|
| 2006 | 1.2 million | $0.8 billion |
| 2009 | 5.0 million | $7.1 billion |
| 2010 | 5.7 million | $7.7 billion |

By 2009, 15% of employers with 10–499 employees and 20% of employers with 500 or more employees offered either an HRA or HSA-eligible plan. These plans covered approximately 21 million people in 2010, which equals 12% of the privately insured population. Given this trend, tax practitioners will likely have an increasing number of clients with HSA tax issues.

**Observation.** Early proponents of HSA-HDHP arrangements argued that by giving individuals more control of their healthcare dollars, the individuals would become more conscious of their healthcare costs. In turn, the proponents predicted that the newly cost-conscious consumers would be a force in the market against rising healthcare prices. (This is why insurance plans offering standard prescription coverage are not qualified HDHPs.)

Interestingly, the Economic Benefit Research Institute (EBRI) study found no relationship between account balances and certain cost-conscious behaviors such as checking prices before getting services or asking for generic drugs instead of brand-name drugs.[24]

## ANNUAL CONTRIBUTION LIMITS[25]

The maximum amount that may be contributed to an HSA each year is limited to an amount specified by the Code, adjusted annually for inflation. For 2011, the following limits apply.

| Type of HDHP | Maximum 2011 HSA Contribution |
|---|---|
| Self-only HDHP | $3,050 |
| Family HDHP | 6,150 |

The maximum contributions are increased by $1,000 for participants age 55 or older. **If both spouses are 55 or older and not enrolled in Medicare, each spouse's HSA contribution limit is increased by $1,000.** If both spouses meet the age requirement, the total contributions under family coverage cannot be more than $8,150. Although the $6,150 may be contributed to either spouse's HSA for 2011, each spouse must make the additional contribution to his or her separately owned HSA.

**Beginning with the first month that an individual is enrolled in Medicare, no HSA contribution is allowed.**

---

23. Fronstin, Paul (Jan. 2011) Health Savings Accounts and Health Reimbursement Arrangements: Assets, Account Balances, and Rollovers, *2006-2010 EBRI Issue Brief,* 353. [www.ebri.org/pdf/briefspdf/IB.Jan11.CEHCS.FinalFlow.03Jan11.pdf] Accessed on May 30, 2011.

24. [www.ebri.org/pdf/PR909.11Jan11.HSA-HRA.pdf] Accessed on Jul. 17, 2011.

25. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Plans.*

Maximum HSA contributions may be limited if the participants do not participate in HDHPs for the entire year. The adjusted limit is the **higher** of:

1. The maximum **prorated** for the number of full months the HDHP was in place, **or**
2. The maximum annual HSA contribution based on the type of HDHP (self-only or family) in place **on December 1** (for calendar-year taxpayers). Note that this amount will be $0 for individuals enrolled in Medicare at any time during the tax year.

**Example 14.** Jan is enrolled in a **self-only** HDHP from January 1, 2011, until her 65th birthday on December 7, 2011. On her birthday, she enrolls in Medicare.

**Method 1.** Jan's 2011 maximum contribution to her HSA is limited to $3,713 as calculated in the following table.

| | | |
|---|---|---|
| 2011 self-only HSA limit | $3,050 | |
| Plus: additional age 55 or older contribution | 1,000 | |
| Maximum 2011 HSA contribution limit | $4,050 | $4,050 |
| Full months of eligibility | 11 | |
| Months per year | ÷ 12 | |
| Proration factor | 0.9167 | × 0.9167 |
| **2011 adjusted HSA contribution limit** | | **$3,713** |

**Method 2.** The maximum HSA contribution is $0 because she is enrolled in Medicare.

The higher maximum contribution is from Method 1. Therefore, Jan may contribute up to $3,713 to her HSA for 2011.

**Caution.** Taxpayers who fund their HSA based on Method 2 are subject to a testing period. They must remain eligible participants in the HDHP through the end of the next tax year unless they die or become disabled. If they fail the testing period, the amount by which Method 2 exceeded Method 1 will be included in income in the year of failure. This income will also be subject to a 10% penalty. The income and additional tax are reported in Part III of Form 8889, *Health Savings Accounts (HSAs)*. However, this amount is not considered an excess contribution and is **not** subject to the 6% excise penalty discussed later.

The maximum contribution is also adjusted for married couples when one of the spouses has family coverage. In this case, **both** spouses are treated as having family coverage as long as **both spouses are eligible** individuals. However, the combined contributions for the couple cannot exceed the annual limit for participants with family HDHP coverage. The contribution limit is split equally between the spouses unless they agree on a different division.

The HSA contribution limit is also reduced by the amount of any employer contribution to the taxpayer's HSA, if the contribution is excludable from the taxpayer's income. This includes amounts contributed through a cafeteria plan.

**Example 15.** Use the same facts as **Example 14,** except that Jan's employer contributed $2,000 to Jan's HSA on her behalf in 2011. Jan's maximum contribution of $3,713 is further reduced by the $2,000 contributed by her employer. **Therefore, Jan is eligible to contribute and deduct a total of $1,713 for her HSA for 2011.**

## EXCESS CONTRIBUTIONS[26]

Contributions that are greater than the annual contribution limits are subject to **income tax** and an additional **6% excise tax**. Excess contributions made by the taxpayer are not deductible. Excess contributions made by the employer are included in gross income. If the excess contribution is not included in box 1 of Form W-2, the excess is reported as "Other income" on line 21 of the taxpayer's Form 1040.

**The 6% excise tax applies to each tax year that the excess contribution remains in the account.** The excise tax does not apply if the taxpayer withdraws the excess and meets the following conditions.

1. The excess contributions are withdrawn by the due date, **including** extensions, of the tax return for the year the contributions were made.
2. The income earned on the withdrawn contributions is also withdrawn.
3. The income on the excess contributions is included in income on the return for the year of withdrawal.

**Example 16.** Roy is a single taxpayer with a self-only HDHP in 2011. He is under age 55, so his 2011 HSA contribution limit is $3,050. In January 2011, Roy contributes $4,000 to his HSA. Roy files for an extension to file his 2011 return, and on October 1, 2012, his accountant advises him that he has contributed too much to his HSA for 2011. His excess HSA contribution is $950 ($4,000 – 3,050).

Roy contacts his HSA trustee, First National Bank. He learns that the bank does not monitor his eligibility to make HSA contributions. He also learns that the $950 in excess contributions earned $20 in interest from January 2011 through October 3, 2012. He withdraws $970 from his HSA on October 3, 2012.

Roy's accountant reports the interest earned of $20 on line 21, "Other income," on Roy's **2011** Form 1040. The $950 is not subject to the 6% excise penalty because he corrected the excess contribution and reported the earnings in income.

Excess contributions that are not withdrawn may be deductible in later years. The excess contribution that can be deducted is the **smaller** of:

1. The maximum HSA contribution limit for the year minus any amounts contributed to the HSA for the year, or
2. The total excess contribution in the HSA at the beginning of the year.

26. Ibid.

**Example 17.** Use the same facts as **Example 16,** except Roy forgets to file for an extension for his 2011 tax return. He does not withdraw the 2011 excess HSA contribution of $950.

Roy's excess contribution of $950 is not deductible. He must include the $57 excise tax ($950 × 6%) on the excess contribution on his 2011 return. Portions of his 2011 Form 8889 and Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, follow.

Form **8889** — **Health Savings Accounts (HSAs)** — OMB No. 1545-0074 — **2011**

Department of the Treasury Internal Revenue Service — ▶Attach to Form 1040 or Form 1040NR. ▶See separate instructions. — Attachment Sequence No. 53

Name(s) shown on Form 1040 or Form 1040NR: **Roy** — Social security number of HSA beneficiary. If both spouses have HSAs, see instructions ▶ **333-19-1919**

***Before you begin:*** Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

**Part I** **HSA Contributions and Deduction.** See the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse.

| | | | |
|---|---|---|---|
| 1 | Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2011 (see instructions). ▶ | ☑ Self-only ☐ Family | |
| 2 | HSA contributions you made for 2011 (or those made on your behalf), including those made from January 1, 2012, through April 17, 2012, that were for 2011. **Do not** include employer contributions, contributions through a cafeteria plan, or rollovers (see instructions) | 2 | 4,000 |
| 3 | If you were under age 55 at the end of 2011, and on the first day of **every** month during 2011, you were, or were considered, an eligible individual with the **same** coverage, enter $3,050 ($6,150 for family coverage). **All others,** see the instructions for the amount to enter | 3 | 3,050 |
| 4 | Enter the amount you and your employer contributed to your Archer MSAs for 2011 from Form 8853, lines 1 and 2. If you or your spouse had family coverage under an HDHP at any time during 2011, also include any amount contributed to your spouse's Archer MSAs | 4 | 0 |
| 5 | Subtract line 4 from line 3. If zero or less, enter -0- | 5 | 3,050 |
| 6 | Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2011, see the instructions for the amount to enter | 6 | 3,050 |
| 7 | If you were age 55 or older at the end of 2011, married, and you or your spouse had family coverage under an HDHP at any time during 2011, enter your additional contribution amount (see instructions) | 7 | 0 |
| 8 | Add lines 6 and 7 | 8 | 3,050 |
| 9 | Employer contributions made to your HSAs for 2011 — 9 | | |
| 10 | Qualified HSA funding distributions — 10 | | |
| 11 | Add lines 9 and 10 | 11 | |
| 12 | Subtract line 11 from line 8. If zero or less, enter -0- | 12 | 3,050 |
| 13 | **HSA deduction.** Enter the **smaller** of line 2 or line 12 here and on Form 1040, line 25, or Form 1040NR, line 25 | 13 | 3,050 |
| | **Caution:** *If line 2 is more than line 13, you may have to pay an additional tax (see instructions).* | | |

**HSA Distributions.** If you are filing jointly and both you and your spouse each have separate HSAs, complete

**For Example 17**

Form **5329**

Department of the Treasury
Internal Revenue Service (99)

**Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts**

▶ Attach to Form 1040 or Form 1040NR.

▶ See separate instructions.

OMB No. 1545-0074

**2011**

Attachment Sequence No. **29**

| Name of individual subject to additional tax. If married filing jointly, see instructions. | Your social security number |
|---|---|
| Roy | 339-19-1919 |

| **Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return** | Home address (number and street), or P.O. box if mail is not delivered to your home | Apt. no. |
|---|---|---|
| | City, town or post office, state, and ZIP code | If this is an amended return, check here ▶ ☐ |

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 58, or

1040, line 5… 41

**Part VII** **Additional Tax on Excess Contributions to Health Savings Accounts (HSAs)**

Complete this part if you, someone on your behalf, or your employer contributed more to your HSAs for 2011 than is allowable or you had an amount on line 49 of your 2010 Form 5329.

| | | | | | |
|---|---|---|---|---|---|
| 42 | Enter the excess contributions from line 48 of your 2010 Form 5329. If zero, go to line 47 | | | 42 | 0 |
| 43 | If the contributions to your HSAs for 2011 are less than the maximum allowable contribution, see instructions. Otherwise, enter -0- | 43 | | | |
| 44 | 2011 distributions from your HSAs from Form 8889, line 16 | 44 | | | |
| 45 | Add lines 43 and 44 | | | 45 | |
| 46 | Prior year excess contributions. Subtract line 45 from line 42. If zero or less, enter -0- | | | 46 | |
| 47 | Excess contributions for 2011 (see instructions) | | | 47 | 950 |
| 48 | Total excess contributions. Add lines 46 and 47 | | | 48 | 950 |
| 49 | **Additional tax.** Enter 6% (.06) of the **smaller** of line 48 **or** the value of your HSAs on December 31, 2011 (including 2011 contributions made in 2012). Include this amount on Form 1040, line 58, or Form 1040NR, line 56 | | | 49 | 57 |

**Part VIII** **Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs)**

Complete this part if you did not receive the minimum required distribution from your qualified retirement plan.

**Example 18.** Use the same facts as **Example 17.** For **2012,** Roy only contributes $1,000 to his HSA. His excess contribution of $950 from 2011 may be attributed to 2012. (For purposes of this example, assume the 2012 contribution limit remains at $3,050.)

Roy redesignates the $950 excess 2011 HSA contribution as a 2012 contribution. The maximum amount that Roy may use to absorb prior year excess contributions is shown below:

| | |
|---|---|
| 2012 annual contribution limit for self-only HSAs (assumed) | $3,050 |
| Less: actual amount contributed for 2012 | (1,000) |
| **Maximum amount available to absorb prior year excess contributions** | **$2,050** |

Because $2,050 is greater than the $950 in excess contributions from 2011, he is allowed to redesignate the $950 as a 2012 contribution. He includes the $950 plus the $1,000 contributed for 2012 as deductible contributions on line 1 of his 2012 Form 8889 (not shown).

Roy does **not** have to pay the 6% excise tax with his 2012 return. However, he must file a 2012 Form 5329 (not shown) to show that the excise tax no longer applies. Line 43 of this Form 5329 is equal to $2,050, the maximum amount available to absorb prior year excess HSA contributions.

## NONCASH CHARITABLE CONTRIBUTIONS[27]

The amount of a taxpayer's charitable contribution deduction for property contributed to a qualified organization is generally the FMV of the property at the time of the contribution. This value is often difficult to ascertain, and some taxpayers are tempted to overstate the value of noncash contributions to a charity.

Because of the inherent temptation and uncertainty of determining the FMV of donated property, Congress and the IRS have placed a number of restrictions on the deductible amount of certain types of property. For example, if the property's FMV is more than the taxpayer's basis, the deductible amount may be limited.

### FAIR MARKET VALUE

A recent court case, *Rolfs v. Comm'r*,[28] demonstrates the importance of using the proper method to determine FMV. It also serves to remind tax practitioners to carefully review the facts and circumstances in each situation, especially when deducting a contribution that is not based on a financial transaction.

**Facts.** In 1998, the taxpayers donated a dilapidated lake house to their local fire department. The donation was made with the understanding that the home was to be used for training exercises, resulting in the destruction of the house.

On their 1998 joint tax return, they filed Form 8283, *Noncash Charitable Contributions*. It showed that the lake house had an adjusted basis of $100,000 and an FMV of $76,000. The $76,000 appraised value was based on a comparison of similar properties with lake houses and without. The appraiser stated that the property was worth $675,000 with the lake house and $599,000 without it. Therefore, the $76,000 difference represented the FMV of the house. The taxpayers deducted the $76,000 as a charitable contribution.



The IRS denied the entire deduction. In Tax Court, the IRS argued that the $76,000 contribution deduction was not allowable because the taxpayers anticipated and received a substantial benefit in exchange for the contribution; namely, demolition services, valued at a minimum of $10,000. **The IRS contended that the FMV of the house did not exceed the $10,000 value of the demolition services received.**

**Holding.** The Tax Court determined that the key factor in the case was the method used to value the house. They cited Treas. Reg. §1.170A-1(c)(2), which requires that the FMV be measured by **the willing buyer/willing seller standard**. They also noted that the FMV must take into account any restrictions or conditions limiting the property's marketability on the date of the contribution.

The court held that the donation of the house, without also conveying the underlying land, created a "constructive severance" of the structure from the land, which substantially restricted the property's marketability. In addition, the taxpayers attached two conditions to the donation.

1. The permissible use of the lake house was restricted to training exercises.
2. The house was to be burned down soon after the conveyance.

**Because of the restrictions on the property's marketability and use, the court held that the taxpayers received a substantial benefit from the demolition and that the benefit exceeded the FMV of the donated house.** Therefore, the court upheld the IRS decision to disallow the charitable contribution deduction.

**However, the court ruled that the taxpayer's reliance on a qualified appraiser and their full disclosure of the transaction with the return met the reasonable cause and good faith standards.** As a result, the court denied the IRS's request to impose accuracy-related penalties.

---

27. IRS Pub. 526, *Charitable Contributions.*

28. *Theodore R. Rolfs and Julia A. Gallagher v. Comm'r,* 135 TC 24 (Nov. 4, 2010).

## CONTRIBUTIONS SUBJECT TO SPECIAL RULES

Special rules apply to donations of the following types of items.

- Clothing or household items
- A car, boat, or airplane
- Taxidermy property
- Property subject to a debt
- A partial interest in property
- A fractional interest in tangible personal property
- A qualified conservation contribution
- A future interest in tangible personal property
- Inventory from the taxpayer's business
- A patent or other intellectual property

Several of these rules are discussed here. For additional information, see IRS Pub. 526, *Charitable Contributions*.

### Clothing and Household Items

To be deductible, donated clothing and household items must be in good used condition or better. An exception to this rule applies if an item is worth more than $500 and a qualified appraisal of the item is included with the return.

### Cars, Boats, and Airplanes

The allowable deduction for vehicles valued at **more than $500** is limited to the **smaller** of:

1. The gross proceeds from the sale of the vehicle by the donee organization, or
2. The vehicle's FMV on the date of the contribution.

The donee organization should provide the taxpayer with Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes*, which shows the gross proceeds from the sale of the vehicle. Copy B of Form 1098-C should be attached to a mailed return or submitted with Form 8453, *U.S. Individual Income Tax Transmittal*, for an e-filed return. The contribution is not deductible if the Form 1098-C is not submitted with the return. The Form 1098-C (or a substitute statement) must be issued within 30 days of the **sale** of the vehicle. However, if one of the following exceptions apply, Form 1098-C must be issued within 30 days of the **donation**.

1. **The vehicle is used or improved by the recipient organization.** If the qualified organization makes a significant intervening use of, or material improvement to, the vehicle before transferring it, the taxpayer can generally deduct the vehicle's FMV at the time of the contribution.
2. **The vehicle is given or sold to a needy individual.** If the qualified organization gives the vehicle, or sells it for a price well below FMV, to a needy individual to further the organization's charitable purpose, the taxpayer can generally deduct the vehicle's FMV at the time of the contribution. This exception does not apply if the organization sells the vehicle at auction.

**Example 19.** Maggie donates a used car to a qualified organization. She bought it three years ago for $9,000. A used car guide shows the FMV for this type of car is $6,000. However, she gets a Form 1098-C from the organization showing the car was sold for $2,900. Neither exception applies.

If Maggie itemizes her deductions, she can deduct $2,900 for her donation. She must attach Form 1098-C and Form 8283, *Noncash Charitable Contributions*, to her return.

### Property Subject to a Debt

If the taxpayer contributes property subject to debt, the FMV of the property is reduced by any **allowable deduction for interest** on the debt which is attributable to any period **after** the contribution.

In addition, if the property is a **bond**, the FMV is reduced by the **smaller** of:

1. Any allowable deduction for interest paid to buy or carry the bond that is attributable to any period before the contribution, or
2. The interest, including bond discount, receivable on the bond that is attributable to any period before the contribution and that is not includible in income because of the taxpayer's accounting method.

If the debt is assumed by the recipient organization, the taxpayer must also reduce the FMV of the property by the amount of the outstanding debt assumed. If the property is sold at a bargain price, the amount of the debt assumed by the recipient is also treated as an amount realized on the sale or exchange of property by the taxpayer.

### Partial Interest in Property

**General Rule.** Generally, contributions of **less than the entire interest** in the property are not deductible. In essence, these gifts do not qualify as completed gifts. For example, a contribution of the right to use property is a contribution of less than the entire interest in that property and is not deductible.

**Example 20.** Peg owns on office building with an attached garage. She donates use of the garage to her church to store items before the annual rummage sale.

Peg has contributed a partial interest in the property. Therefore, she is not entitled to a charitable deduction for the contribution.

**Example 21.** Darrell owns a vacation home on the beach in Gulf Shores, which he sometimes rents to others. For a fund-raising auction at the local animal shelter, he donated the right to use the vacation home for one week. Cari won the bidding at a price equal to the FMV of the rental value of the home for one week.

Darrell cannot claim a charitable contribution deduction because of the partial interest rule. Cari cannot claim a deduction either, because she received a benefit equal to the amount she paid at the charitable auction.

**Exceptions to the Partial Interest Rule.** The following qualify as charitable donations, even though the entire interest in the property is not relinquished.

1. A remainder interest in the taxpayer's personal home or farm (A remainder interest is one that passes to a beneficiary after the end of an earlier interest in the property. For example, a taxpayer might give their alma mater ownership of their home after they die, while retaining the right to live in the home during their lifetime.)
2. An undivided part of the taxpayer's entire interest (This must consist of a part of every substantial interest or right the donor owns in the property and must last as long as the donor's interest in the property lasts. For example, if the donor contributes voting stock to a qualified organization but keeps the right to vote the stock, the donor has not contributed an undivided part of the entire interest and cannot deduct the contribution.)
3. A partial interest that would be deductible if transferred to certain types of trusts
4. A qualified conservation contribution

**Note.** For information on calculating the value of a contribution of a partial interest in property, see IRS Pub. 561, *Determining the Value of Donated Property*.

7

### Fractional Interest in Tangible Personal Property

Special rules apply to contributions of **fractional interests** in **tangible personal property**. A fractional interest in property is an **undivided portion** of the entire interest in the property. This type of donation is most often associated with the right to possess works of art and valuable collectibles. For example, an art museum's right to possess a painting for three months of each year is a fractional interest in the property.

A fractional interest in tangible personal property is **not** deductible unless all interests in the property are held immediately before the contribution by:

1. The taxpayer, or
2. The taxpayer **and** the organization receiving the contribution.

If, at a later date, the taxpayer makes an additional contribution of another fractional interest in the property, the contribution is limited to the **smaller** of the prorated value of the property's FMV at the time of:

- The initial fractional contribution, or
- The additional contribution.

**Example 22.** Patty owns a sculpture created by the famous Colton Turner. In 2009, she gave the Tazewell County Historical Society the right to exhibit the sculpture for one month of each year. In 2009, the FMV of the piece was $12,000. Patty's 2009 charitable deduction was 1/12 of the value, or $1,000.

Colton's fame grew, and in 2011 people were coming from all over the world to view this early work of the renowned artist. To meet the public demand, Patty gave the historical society the right to display the piece for **two additional months** each year. At the time Patty gave the second fractional interest to the charity, the sculpture was valued at $36,000.

Patty's 2011 contribution is limited to $2,000, as shown below:

| | | |
|---|---|---|
| Smaller of the FMV at the time of: | | |
| 1. The initial contribution | $12,000 | |
| 2. The additional contribution | 36,000 | |
| FMV allowable for calculating the 2011 contribution | | $12,000 |
| Additional 2 months | 2 | |
| Months in year | ÷ 12 | |
| Proration factor | 0.1667 | × 0.1667 |
| **2011 deductible charitable contribution** | | **$ 2,000** |

Even though the sculpture is exhibited every year, **the charitable deduction may only be taken once for the initial contribution and once for the additional exhibition period.**

**Observation.** In **Example 22,** Patty would receive **no** charitable contribution if she donated the 2011 fractional interest to a **different** charitable organization. This is because after her original 2009 donation, only the Tazewell County Historical Society meets the ownership requirement.

Fractional interests are also subject to recapture provisions. The recaptured charitable contribution is subject to income tax, interest, and a 10% additional tax. According to an article published by Withers Bergman, this provision was added because:

> *A major perceived abuse of fractional interest gifts involved taxpayers who made a gift and took a deduction, but continued to enjoy exclusive use of the property for a substantial period. Legally, the charity could always insist on physical possession for a portion of the year, but in practice most charities did not. The costs of transportation, the need to rearrange a collection to accommodate a short exhibit of the fractionally owned work, and the risk of offending present or future donors all weighed against enforcing such rights. To eliminate this perceived abuse, the deduction is now "recaptured" if a maximum donation period is exceeded or if an actual use requirement is not satisfied.*[29]

The deduction must be recaptured if **both** of the following statements are true.

1. The fractional interest was contributed after August 17, 2006.
2. The rest of the taxpayer's interests in the property were not contributed to a qualified organization on or before the earlier of:
   a. The date that is 10 years **after** the date of the initial contribution, or
   b. The date of the taxpayer's death.

Recapture is also required in any case in which the qualified organization has not taken substantial **physical possession** of the property **and used it** in a way related to its purpose during the period beginning on the date of the initial fractional contribution and ending on the earlier of:

- The date that is 10 years after the date of the initial contribution, or
- The date of the taxpayer's death.



### Qualified Conservation Contribution

A qualified conservation contribution is a contribution of a **qualified real property interest** to a qualified organization to be used only for conservation purposes. For purposes of a qualified conservation contribution, a qualified organization is:

- A governmental unit;
- A publicly supported charitable, religious, scientific, literary, or educational organization; or
- An organization that is controlled by, and operated for the exclusive benefit of, a governmental unit or a publicly supported charity.

The organization also must have a commitment to protect the conservation purposes of the donation and must have the resources to enforce the restrictions.

A **qualified real property interest** is any of the following interests in real property.

- The taxpayer's entire interest in real estate other than a mineral interest
- A remainder interest
- A restriction (granted in perpetuity) on the use that may be made of the real property

---

29. *Fractional Interest Gifts of Art: Back to Stay or Going Away?* (Oct. 1, 2008). Withersworldwide. [www.withersworldwide.com/news-publications/fractional-interest-gifts-of-art-back-to-stay-or-going-away] Accessed on May 31, 2011.

The contribution must be made for one of the following **conservation purposes.**

1. Preserving land areas for outdoor recreation by, or for the education of the general public
2. Protecting a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem
3. Preserving open space, including farmland and forest land, if it yields a significant public benefit (It must be either for the scenic enjoyment of the general public or under a clearly defined federal, state, or local governmental conservation policy.)
4. Preserving a historically important land area or a certified historic structure

If a building is a **certified historic structure** in a registered historic district, a contribution of an easement or other restriction on the exterior of the building is deductible only if it meets **all** of the following **three** conditions.

1. The restriction must preserve the entire exterior of the building (including its front, sides, rear, and height) and must prohibit any change to the exterior of the building that is inconsistent with its historical character.
2. The taxpayer and the organization receiving the contribution must enter into a written agreement certifying, under penalty of perjury, that the organization:
   a. Is a qualified organization with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and
   b. Has the resources to manage and enforce the restriction and a commitment to do so.
3. The taxpayer includes with their tax return for the year of the contribution:
   a. A qualified appraisal,
   b. Photographs of the building's entire exterior, and
   c. Descriptions of all restrictions on development of the building, such as zoning laws and restrictive covenants.

If the taxpayer claimed the rehabilitation credit on Form 3468, *Investment Credit,* for the building for any of the five years before the year of the contribution, the deduction is reduced.[30]

If the taxpayer claims a deduction of more than $10,000, the deduction is not allowed unless the taxpayer pays a $500 filing fee. See Form 8283-V, *Payment Voucher for Filing Fee Under Section 170(f)(13)*, and its instructions for more information.

**More Information**

- For information about determining the FMV of qualified conservation contributions, see IRS Pub. 561, *Determining the Value of Donated Property.*
- For information about the percentage of income limits that apply to deductions for this type of contribution, see IRS Pub. 526, *Charitable Contributions*.
- For more information about qualified conservation easement donations, see the Agriculture-Related Rulings and Cases section in Chapter 11, Agricultural Issues and Rural Investments.

30. IRC §170(f)(14).

### Future Interest in Tangible Personal Property

The donation of a future interest in tangible personal property is only deductible after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than the taxpayer, a related person, or a related organization. A future interest is any interest that begins at some future time, regardless of whether it is designated as a future interest under state law.

Related persons include the taxpayer's:

- Spouse,
- Children including stepchildren,
- Grandchildren,
- Brothers,
- Sisters, or
- Parents.

Related organizations may include a partnership or corporation in which the taxpayer has an interest, or an estate or trust with which the taxpayer has a connection.



## PROPERTY THAT DECREASED IN VALUE

If the taxpayer contributes property with an FMV that is less than its basis, the deduction is limited to its FMV. Basis is generally what the taxpayer paid for the item. Exceptions apply to property that the taxpayer:

- Received as a gift or inheritance;
- Used in a trade, business, or activity conducted for profit; or
- Claimed for a casualty loss deduction.

Common examples of property that decreases in value include clothing, furniture, appliances, and cars.

## PROPERTY THAT INCREASED IN VALUE

If the taxpayer contriibutes property with an FMV that is **more** than its basis, different rules apply to computing the deduction, depending on whether the property is:

- Ordinary income property, or
- Capital gain property.

### Ordinary Income Property

Property is considered ordinary income property if its sale at FMV on the date it was contributed would have resulted in ordinary income or in short-term capital gain to the contributor. Examples of ordinary income property are:

- Inventory,
- Works of art created by the donor,
- Manuscripts prepared by the donor, and
- Capital assets held one year or less.

Property used in a trade or business is considered ordinary income property to the extent of any depreciation recapture. This is the same as if the property had been sold at its FMV at the time of contribution.

The deductible amount of a contribution of ordinary income property is its FMV minus the amount that would be ordinary income or short-term capital gain if the property were sold for its FMV. **Generally, this rule limits the deduction to the basis in the property.**

### Capital Gain Property

Property is capital gain property if its sale at FMV on the date of the contribution would have resulted in **long-term capital gain**. Capital gain property includes capital assets held more than one year.

Capital assets include most items of property that are owned and used for personal purposes or investment. Examples of capital assets are stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes. For purposes of calculating the charitable contribution, capital assets also include certain real property and depreciable property used in a trade or business and, generally, held for more than one year.

**The deduction for a gift of capital gain property is generally equal to the FMV of the gift at the time of the donation.**

**Example 23.** Murphy owns 40 acres of farm ground that has been passed down by her family for generations. Her father gave her the acreage in June 1990 when his health started failing; he is still alive. Her grandmother gave Murphy's father the farmland when he got married in 1945. Murphy's grandmother inherited the property in 1924 from a great uncle. It is estimated that the property was worth $143 per acre when Murphy's grandmother inherited it in 1924. In 2011, the land is worth $6,000 per acre.

Murphy has no close relatives to whom to bequeath the acreage. In 2011, the local park district initiates a fundraising campaign to build a new park in her neighborhood. The park will include a special area for dogs to romp and mingle. It also includes an area devoted to handicapped-accessible playground equipment. Murphy decides to sell the property and donate half of the proceeds to the park project. She consults her favorite tax advisor, Bill.

Bill advises Murphy to donate a half interest in the real estate to the park district before the sale. Unlike many taxpayers, Murphy follows her advisor's advice. In July 2011, she quit claims the property to the park district and herself as joint owners. In August, the property sells for $240,000.

Murphy's original basis in the acreage is $5,720 (40 acres × $143/acre). She gives half of her ownership to the park district, so her remaining basis is half that amount, or $2,860.

The FMV at the time of the donation is equal to the sales price of $240,000. Because she donated an undivided half interest in the property to the park district, her contribution is valued at $120,000. She is allowed a charitable contribution deduction of $120,000, subject to AGI limitations.

Prior to completing her 2011 return, Murphy has the property appraised by a professional appraiser. The appraiser certifies that the property was sold for its FMV at the time of the donation. Murphy must complete Section B of Form 8283 and file it with her 2011 return. She is not required to file the appraisal with the return; however, she must keep it in her records in the event of an IRS inquiry.[31] In addition, the **appraiser** must complete and sign Part III of the form and a **representative of the park district** must complete and sign Part IV of the form.

Murphy's completed Section B of Form 8283 is shown next.

---

31. Instructions for Form 8283, *Noncash Charitable Contributions* (Revised Dec. 2006).

## For Example 23

Form **8283** (Rev 12-2006) Page **2**

| Name(s) shown on your income tax return | Identifying number |
|---|---|
| **Murphy Example** | **333-25-2525** |

**Section B. Donated Property Over $5,000 (Except Certain Publicly Traded Securities) —** List in this section only items (or groups of similar items) for which you claimed a deduction of more than $5,000 per item or group (except contributions of certain publicly traded securities reported in Section A). An appraisal is generally required for property listed in Section B (see instructions).

**Part I — Information on Donated Property —** To be completed by the taxpayer and/or the appraiser.

**4** Check the box that describes the type of property donated:

- ☐ Art* (contribution of $20,000 or more)
- ☐ Art* (contribution of less than $20,000)
- ☐ Collectibles**
- ☐ Qualified Conservation Contribution
- ☒ Other Real Estate
- ☐ Intellectual Property
- ☐ Equipment
- ☐ Securities
- ☐ Other

*Art includes paintings, sculptures, watercolors, prints, drawings, ceramics, antiques, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and other similar objects.
**Collectibles include coins, stamps, books, gems, jewelry, sports memorabilia, dolls, etc., but not art as defined above.
**Note:** In certain cases, you must attach a qualified appraisal of the property. See instructions.

| 5 | (a) Description of donated property (if you need more space, attach a separate statement) | (b) If tangible property was donated, give a brief summary of the overall physical condition of the property at the time of the gift | (c) Appraised fair market value |
|---|---|---|---|
| A | **1/2 Interest in 40 acres of real estate** | | **120,000** |
| B | | | |
| C | | | |
| D | | | |

| | (d) Date acquired by donor (mo, yr) | (e) How acquired by donor | (f) Donor's cost or adjusted basis | (g) For bargain sales, enter amount received | See instructions (h) Amount claimed as a deduction | (i) Average trading price of securities |
|---|---|---|---|---|---|---|
| A | **06/1990** | **Gift** | **2,860** | | **120,000** | |
| B | | | | | | |
| C | | | | | | |
| D | | | | | | |

**Part II — Taxpayer (Donor) Statement —** List each item included in Part I above that the appraisal identifies as having a value of $500 or less. See instructions.

I declare that the following item(s) included in Part I above has to the best of my knowledge and belief an appraised value of not more than $500 (per item).

Enter identifying letter from Part I and describe the specific item. (See instructions). ► ____________

Signature of taxpayer (donor) ► Date ► **4/15/2012**

**Part III — Declaration of Appraiser**

I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons. And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.

Also, I declare that I hold myself out to the public as an appraiser or perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this Form 8283 may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). In addition, I understand that a substantial or gross valuation misstatement resulting from the appraisal of the value of the property that I know, or reasonably should know, would be used in connection with a return or claim for refund, may subject me to the penalty under section 6695A. I affirm that I have not been barred from presenting evidence or testimony by the Office of Professional Responsibility.

**Sign Here** Signature ► Title ► **Certified Agricultural Appraiser** Date ► **8/01/2011**

| Business address (including room or suite no.) | Identifying number |
|---|---|
| **2500 Burbon St** | **52-2525255** |
| City or town | State ZIP code |
| **Metropolis** | **IL 62960** |

**Part IV — Donee Acknowledgment —** To be completed by the charitable organization.

This charitable organization acknowledges that it is a qualified organization under section 170(c) and that it received the donated property as described in Section B, Part I, above on the following date ► **7/30/2011** (Date)

Furthermore, this organization affirms that in the event it sells, exchanges, or otherwise disposes of the property described in Section B, Part I (or any portion thereof) within 3 years after the date of receipt, it will file **Form 8282**, Donee Information Return, with the IRS and give the donor a copy of that form. This acknowledgment does not represent agreement with the claimed fair market value.

Does the organization intend to use the property for an unrelated use? . . . . . . . ► ☒ Yes ☐ No

| Name of charitable organization (donee) | | Employer identification number |
|---|---|---|
| **Local Park District** | | **37-5252525** |
| Address (number, street and room or suite no.) | City or town | State ZIP code |
| **3000 Stadium Dr** | **Hometown** | **IL 62960** |
| Authorized signature | Title | Date |
| | **Director** | **3/15/2012** |

FDIZ1812 12/31/10 Form **8283** (Rev 12-2006)

7

**Observations for Example 23.**

1. Although not shown in the facts, Murphy's 2011 AGI **before the land sale** is $290,000, consisting of $200,000 of qualified dividends and $90,000 of wages. Her capital gain from the sale is $117,140 ($120,000 less her remaining basis of $2,860). She does not have any other itemized deductions. Murphy's total federal income tax for 2011 is $37,341.

2. If Murphy had sold the land, then made the cash donation, her total federal tax would be $55,467. Bill's advice saved Murphy $18,126 ($55,467 − 37,341).

3. In addition to the Form 8283 that Murphy must include with her 2011 return, the park district must file Form 8282, *Donee Information Return,* with the IRS within 125 days of the sale.[32] It must also provide Murphy with a copy.

4. Murphy's income is sufficient so that 100% of her donation is allowed as a 2011 deduction. If her income were lower, her deduction would be limited to 30% of her AGI. Any contribution not used in 2011 would carry forward to her 2012 return. For more information about AGI limitations, see IRS Pub. 526.

5. The limitation of the deduction for donations of partial interests does not apply to this sale. The park district received ownership in 100% of the rights in its share of the real estate she donated.

6. The special rules for contributions of fractional interests also do not apply. Those rules apply only to tangible personal property. Real estate is not tangible personal property.

7. If a recipient organization **sells** donated **tangible personal property** instead of using the property for its charitable function, the contribution deduction is limited. This limitation is discussed next. However, the limitation does not apply to Murphy's donation because she donates **real property**, not tangible personal property.

**In certain situations, the deduction must be reduced by any amount that would have been long-term capital gain if the property were sold for its FMV.** This limitation applies in the following circumstances.

1. The property (other than qualified appreciated stock) is contributed to certain private nonoperating foundations.
2. The 50% AGI contribution limit instead of the special 30% AGI contribution limit is applied.
3. The contributed property is qualified intellectual property.
4. The contributed property is certain taxidermy property.
5. The contributed property is tangible personal property that:
   a. Is put to an unrelated use by the charity, or
   b. Has a claimed value of more than $5,000 and is sold, traded, or otherwise disposed of by the qualified organization during the year in which the contribution is made, and the qualified organization has not made the required certification of exempt use. The required certification may be made using Part IV of Form 8282. Part IV is only required for tangible personal property.

The term **unrelated use** means a use that is unrelated to the exempt purpose or function of the charitable organization. For a governmental unit, it means the use of the contributed property for other than exclusively public purposes.

---

32. Form 8282, *Donee Information Return* (Revised Apr. 2009), p. 3.

**Example 24.** Frank donates a painting to his alma mater. The painting is placed in the university's library for display and study by art students.

The school's use of the painting is related to its educational purpose, so it is **not** an unrelated use. Frank deducts the full FMV of the painting on his tax return.

**Example 25.** Samantha donates a painting to her alma mater. The painting is sold by the university as part of a fundraising auction. The proceeds of the auction are used to support the school's educational mission.

Despite the fact that the proceeds of the sale are used for educational purposes, the painting itself is not. This is an **unrelated use** and Samantha's deduction is limited to the lesser of her basis or the FMV of the painting.

Part of the charitable contribution deduction must be **recaptured** if **all** of the following are true.

1. The taxpayer claims a charitable deduction of more than $5,000 for a donation of tangible personal property.
2. The deduction is more than the taxpayer's basis in the property.
3. The organization sells, trades, or otherwise disposes of the property after the year it was contributed but within three years of the contribution.
4. The organization does **not** provide a written statement, signed by an officer of the organization under penalty of perjury, that either:
   a. Certifies its use of the property was substantial and related to the organization's purpose, or
   b. Certifies its intended use of the property became impossible.

7

If all the preceding statements apply, the taxpayer recaptures the difference between the deduction claimed and the taxpayer's basis in the property. This recapture is reported on the "Other income" line of Form 1040 in the year the organization sells/disposes of the property.

## ORDINARY OR CAPITAL GAIN INCOME INCLUDED IN GROSS INCOME

The charitable contribution is **not** reduced if the ordinary or capital gain income is included in gross income in the same year as the contribution. This may happen when an installment or discount obligation is transferred or when the taxpayer assigns income to a charitable organization. For contributions of an obligation related to the sale of property that is reported under the installment method, see IRS Pub. 537, *Installment Sales*.

**Example 26.** Josh donates an installment note to a qualified organization. The note has an FMV of $10,000 and a basis of $7,000.

As a result of the donation, Josh has a short-term capital gain of $3,000 ($10,000 − $7,000), which is included in his income for the year. His charitable contribution is $10,000.

### Bargain Sales

A sale or exchange for less than the property's FMV to a qualified organization is partly a charitable contribution and partly a sale or exchange. The part of the bargain sale that is a sale or exchange may result in a taxable gain. The part of the sale that is a charitable contribution and the determination of the reportable gain is calculated as follows.

**Step 1.** Subtract the amount received for the property from the property's FMV at the time of sale. This is the FMV of the contributed portion.

**Step 2.** Prorate the adjusted basis of the contributed property between the portion contributed and the portion sold.

**Step 3.** Determine whether the amount of the charitable contribution is the FMV of the contributed portion (Step 1) or is limited to the adjusted basis of the contributed portion (Step 2). Generally, if the property sold is capital gain property, the charitable contribution equals the FMV of the contributed portion. If it is ordinary income property, the charitable contribution equals the adjusted basis of the contributed portion.

**Step 4.** Determine the reportable capital gain by subtracting the sales portion of the adjusted basis (Step 2) from the sales proceeds (Step 1).

The following example shows how this calculation is performed for an asset that qualifies as ordinary income property.

**Example 27.** Krissy purchased 100 shares of PTS 75, Inc., for $4,000 in January 2011. In September 2011, she sells the shares to the local animal shelter for $2,000. The shares have an FMV of $10,000 at the time of the gift.

The property is **ordinary income property** because Krissy held the shares for **less than one year**. Therefore, her charitable contribution deduction is limited to the basis of the contributed portion (Step 2 below). She also must report a gain on the portion of the stock that was sold to the shelter (Step 4 below). The following illustrates the breakdown of the transaction for tax purposes.

**Step 1.** $10,000 FMV – $2,000 sales proceeds = $8,000 FMV of contributed portion

**Step 2.** $4,000 adjusted basis × ($2,000 sales proceeds ÷ $10,000 total FMV) = **$800 sales portion**

$4,000 adjusted basis × ($8,000 contributed portion ÷ $10,000 total FMV) = **$3,200 contributed portion**

**Step 3.** Charitable deduction = $3,200 adjusted basis of contributed portion as calculated in Step 2

**Step 4.** $2,000 sales proceeds – $800 sales portion of adjusted basis from Step 2 = **$1,200 reportable capital gain**

## PENALTIES

The taxpayer may be liable for penalties if the value or adjusted basis of donated property is overstated.

**20% Penalty.** The penalty is 20% of the amount of underpaid tax caused by the overstatement, if:

1. The value or adjusted basis claimed is **150%** or more of the correct amount, and
2. The tax was underpaid by more than $5,000 because of the overstatement.

**40% Penalty.** The penalty is 40%, rather than 20%, if:

1. The value or adjusted basis claimed is **200%** or more of the correct amount, and
2. The tax was underpaid by more than $5,000 because of the overstatement.

## DEPENDENCY EXEMPTION FOR EMANCIPATED CHILDREN

Effective for tax years beginning after July 2, 2008, the IRS has clarified the meaning of the word **"custody"** as used in IRC §152(e) for dependency purposes in a way that may be detrimental for many taxpayers. In general, if a **custodial parent** signs a written release, a **noncustodial parent** may claim the dependency exemption for their child.

**If a child is emancipated under state law, the child is treated as not being in the custody of either parent.**[33] Accordingly, **if the child is an adult, there is no custodial parent that can release the exemption to the other parent.** In most states, the age of emancipation is 18.

This distinction is significant because it effectively prevents parents of college students from taking turns claiming their children's exemptions. An adult child away at school will only meet the residency test for the parent who lives where the child maintains a permanent residence.

Assuming the age and relationship tests are also met, the child is a qualifying child **only** for the parent with whom they reside. One of the requirements for claiming an exemption for someone who is **not** the taxpayer's qualifying child is that the child not be **anyone** else's qualifying child.[34] Therefore, only the parent who resides at the child's permanent residence qualifies to claim the child's dependency exemption. Because the education credits and deduction are tied to the exemption, the tax consequences may be considerable.

> **Note.** Tax practitioners who disregard this regulation should consider filing Form 8275-R, *Regulation Disclosure Statement*, with the return of any taxpayer who uses the special rule for divorced or separated parents to claim an exemption for an adult child who does not live with that taxpayer.



## CHANGES TO FORM 1099-B

The Energy Improvement and Extension Act of 2008 amended Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* reporting requirements for brokers by mandating expansive new reporting requirements for sales of **"covered"** securities on Form 1099-B. These provisions are effective for corporate stock sales starting on January 1, 2011. The changes also direct brokers to follow customer instructions and elections when determining cost basis. At first glance, it would seem that accurately reporting gains and losses will be less burdensome to taxpayers and preparers. However, this is not "burden reduction" legislation. The purpose is to increase tax collections and may provide more confusion in the near future. Unless a broker has been involved in 100% of the customer's transactions, the broker may not have the information necessary to determine the basis of the customer's transactions.

> **Note.** Unless the customer specifies otherwise, the basis is reported using a first-in first-out method.

If a taxpayer sells a "specified security" that is "covered" under the effective dates of the legislation, the broker must report the adjusted cost basis of the security on Form 1099-B, and whether the gain/loss is short-term or long-term. In the past, only the gross sales proceeds were reported.

The term **specified security** includes any share of stock (or any interest treated as stock) in a corporation.[35]

---

33. Treas. Reg. §1.152-4, Examples 6 and 7 (July 2, 2008).

34. IRC §152(d)(1)(D).

35. Instructions for Form 1099-B (2011).

A **covered security** includes any of the following.[36]

- A specified security acquired after 2010, except stock for which the average basis method is available
- Stock for which the average basis method is available and that is acquired in an account after 2011
- A specified security transferred to an account if the broker or other account custodian receives a transfer statement reporting the security as a covered security
- A security acquired due to a stock dividend, stock split, reorganization, redemption, stock conversion, recapitalization, corporate division, or other similar action, if the basis of the acquired security is determined from the basis of a covered security

A "noncovered" security is one that does not meet the definition of a covered security and does not fall under the new reporting rules.

The following securities are not covered securities.[37]

- Stock acquired in 2011 that is transferred to a dividend reinvestment plan (However, a covered security acquired in 2011 that is transferred to a dividend reinvestment plan after 2011 remains a covered security.)
- A security acquired through a stock dividend, stock split, reorganization, redemption, stock conversion, recapitalization, corporate division, or other similar action if the basis of the acquired security is determined from the basis of a **noncovered** security
- A security that did not have to be reported on Form 1099-B when acquired because it was acquired from an exempt recipient or from an exempt foreign person
- Certain securities owned by a foreign intermediary or flow-through entity

Securities acquired before the effective date are considered "noncovered" and are kept in a separate pool for cost basis reporting for that investment. Brokers are not required to report basis for any securities acquired before 2011. If the broker has cost basis information for the shares purchased before the effective date, they can make a single account election.

The following are other reporting provisions.[38]

- If a taxpayer does not want to use the broker-selected default method of cost basis reporting, the taxpayer's method selection must be made either in writing or electronically to the brokerage firm. The request cannot be verbal.
- Taxpayers should continue to comply with IRC §1091 regarding wash sale rules. Brokers are now only required to report losses from wash sales when the securities have the same CUSIP number and the purchase and sale occur in the same account. Taxpayers must still comply, however, with the wash sale rules whether the transactions occur in the same or different accounts.
- In the past for short sales, brokers were required to report the sales proceeds in the year in which the short sale occurred. Brokers are now required to report short sales for the year in which the short sale is closed.
- S corporations are also subject to reporting requirements for sales of covered securities that they acquire on or after January 1, 2012.

**Note.** Although enhanced reporting is required from the brokerage companies, it is the taxpayer's responsibility to make sure they agree with the brokerage firm's reporting. If the taxpayer reports an amount different than the broker's reported amount, it is likely that a proposed adjustment will be made by the IRS. The taxpayer then will have to verify the cost basis or have the brokerage company correct any errors. This may be very difficult to accomplish. Consequently, the taxpayer should make sure their records and the brokerage company's records agree before issuance of Forms 1099.

36. Ibid.

37. Treas. Reg. §1.6045-1(a)(15)(iv).

38. *Cost Basis Reporting Overview and FAQs*. IRS. [www.irs.gov/taxpros/article/0,,id=237099,00.html] Accessed on Jul. 7, 2011.

## 2011 SOCIAL SECURITY CHANGES

### REDUCED SOCIAL SECURITY TAXES FOR EMPLOYEES

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act) reduced the employee share of the old-age, survivors, and disability insurance (OASDI) from 6.2% to 4.2% for calendar year 2011 only. The employer's share of the OASDI tax remains unchanged at 6.2%. This 1-year payroll tax cut replaces the making work pay credit, which expired after 2010 and is designed to deliver the tax benefit incrementally over the year. Under this 2011 payroll tax holiday, the maximum benefit to be derived is $2,136 per wage earner, or 2% of the OASDI taxable wage limit of $106,800.

The lower taxes will not affect the Social Security system's finances because the trust fund will be reimbursed for the full amount of the tax break from the general fund of the Treasury. As a result, the Social Security trust fund will no longer be funded completely by citizen contributions. "This pretty much ends the claim that Social Security is self-financing or that it doesn't contribute to the budget deficit," stated Andrew Biggs, a former deputy commissioner of the Social Security Administration.[39]

### REDUCED SOCIAL SECURITY TAXES FOR SE INCOME

The 2010 Tax Relief Act also reduced the total self-employment (SE) tax rate by 2%, from 15.3% to 13.3% for calendar year 2011 only. The tax rate is a combination of the OASDI rate of 10.4% (historically 12.4%) and Medicare tax rate of 2.9%. The OASDI tax continues to apply to a maximum earnings amount of $106,800.

7

Self-employed taxpayers are allowed to **deduct half of their SE tax liability without the temporary reduction** as an adjustment in arriving at AGI. For 2011, the computation is:

- 59.6 % of the applicable OASDI taxes[40] (59.6% × 10.4% = 6.20%), plus
- 50% of the applicable Medicare tax (50% × 2.9%= 1.45%).

**Accordingly, the 2011 deduction remains at 7.65% of SE income.**

39. [http://money.usnews.com/money/retirement/articles/2011/01/18/4-social-security-changes-coming-in-2011] Accessed on Jul. 5, 2011.

40. The 59.6% rate replaces the 50% deduction allowed under the previous law. The revised rate allows the self-employed individual to deduct the full amount of the employer portion of SECA taxes. The employer OASDI tax rate for 2011 is 6.2% while the employee portion is 4.2%, for a combined rate of 10.4%. Thus, the employer's share of total OASDI taxes is 6.2% ÷ 10.4%, or 59.6%.

**Example 28.** John has $20,000 of wage income and $120,000 of net SE income. A comparison of John's 2010 and 2011 SE tax and his deduction for SE tax in arriving at federal AGI is as follows:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| **Calculation of SE tax** | | | | |
| SE income | $120,000 | | $120,000 | |
| Multiply by 92.35% | × .9235 | | × .9235 | |
| | $110,820 | | $110,820 | |
| Medicare tax at 2.9% | × .029 | | × .029 | |
| | $ 3,214 | $ 3,214 | $ 3,214 | $ 3,214 |
| Maximum amount subject to OASDI | $106,800 | | $106,800 | |
| Less: wages | (20,000) | | (20,000) | |
| Amount subject to OASDI | $ 86,800 | | $ 86,800 | |
| OASDI tax rate | 10.4% | | 12.4% | |
| OASDI tax | $ 9,027 | 9,027 | $ 10,763 | 10,763 |
| Total SE tax assessed | | $12,241 | | $13,977 |
| **Deduction for SE tax in arriving at AGI** | | | | |
| Half of SE tax | | N/A | | $ 6,989 |
| OASDI tax at 59.6% ($9,027 × 59.6%) | | $ 5,380 | | N/A |
| Medicare tax at 50% ($3,214 × 50%) | | 1,607 | | N/A |
| Total deduction | | $ 6,987 | | $ 6,989 |

The 2011 SE tax reduction of $1,736 ($13,977 − $12,241) is the maximum reduction per individual of $2,136 less the benefit received on John's wages of $400 ($20,000 wages × 2% OASDI reduction). The amount of the deduction for SE tax used in arriving at AGI is unchanged for 2011.

## FUTURE SOCIAL SECURITY AND MEDICARE TAX INCREASES

Wage earners and self-employed individuals will see their social security tax rate increase in 2012 after the expiration of the current payroll tax holiday. Some individuals will see an additional increase in their Medicare taxes for taxable years beginning in 2013, when two tax increases are scheduled to take effect.

The **first Medicare tax increase** is a 0.9% increase in the employee portion (from 1.45% to 2.35%) for wages and SE income on earnings in excess of $200,000 per individual ($250,000 for MFJ taxpayers and $125,000 for MFS taxpayers).

Employers are responsible for collecting and remitting this additional tax when wages exceed $200,000. Employers do not take into account wages of an employee's spouse; thus, if the $250,000 threshold is exceeded, the additional tax is calculated and assessed on the individual's income tax return. The employer portion of the Medicare tax remains unchanged at 1.45%.

For self-employed individuals, the additional 0.9% tax applies to SE income that exceeds the threshold amount (reduced by any wages subject to FICA tax). **Self-employed individuals cannot deduct any of the additional tax.**

This additional 0.9% Medicare tax could possibly be both withheld by the employer and calculated and assessed on the individual's tax return.

The **second Medicare tax increase** for 2013 is a 3.8% Medicare tax on investment income of the taxpayer (individuals, estates, and trusts), as discussed earlier.

**Planning Pointer.** Preparers must consider the potential additional Medicare taxes in calculating their clients' estimated and/or withheld taxes for 2013 in order to avoid the estimated tax penalty.

**Note.** For more information about 2013 Medicare tax increases, see Chapter 12, New Legislation, in the 2010 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

## SOCIAL SECURITY PAYBACK OPTION CURTAILED

The Social Security Administration (SSA) recently announced that retirees would no longer be able to receive an interest-free loan from the Social Security trust fund.[41] In the past, social security beneficiaries were allowed to suspend benefits retroactively, repay previous amounts received, and then reclaim benefits at a higher amount. Beneficiaries could use the retroactive voluntary suspension to repay benefits and then reapply for higher benefits at a later age.

The SSA changed this policy effective **December 8, 2010,** in order to prevent abuse and maintain flexibility for beneficiaries. Under the new rules, social security beneficiaries are only allowed to withdraw an application for retirement benefits within 12 months of the first month of entitlement. Application withdrawals are limited to one per lifetime.[42]

Retirees are still allowed to temporarily suspend their benefits and restart them later for a higher benefit but only for the months they did not receive payments and for future benefits beginning the month after the request is made.

## SOCIAL SECURITY PAPER CHECKS

Anyone applying for social security benefits on or after May 1, 2011, will receive their benefit payments electronically. Those who currently receive paper checks must switch to electronic deposit by March 1, 2013. Currently, electronic deposit is available either by direct deposit or direct express card (prepaid debit card).

## CLAIM OF RIGHT DOCTRINE

The claim of right doctrine requires a taxpayer to recognize income if they receive or have control over the income even though they do not have a fixed right to the income. For income to qualify as being received, there must be a receipt of cash or property that ordinarily constitutes income rather than loans, gifts, or deposits that are returnable. This law originated in large part in the *North American Oil Consolidated*[43] decision. This court decision indicated that a taxpayer must report the receipt of income for the time that they have control over it even though they may be liable to repay it at a later time. The courts limited the claim of right doctrine to preclude the IRS from requiring taxpayers to recognize income if there are significant restrictions on the taxpayer's disposition of the income, as occurred in the *Smarthealth*[44] case.

When taxpayers are required to return the income in a year subsequent to the year they reported the income, the taxpayer generally is allowed to take a deduction for the returned amount in the tax year of the return. The type of deduction depends on the type of income reported in the earlier year. The repayment is generally reported on the same form or schedule on which the income was previously reported. If the amount reported is wages, unemployment compensation, or other nonbusiness income, it must be deducted as a miscellaneous itemized deduction.[45]

Frequently, the taxpayer may experience a net negative tax consequence when their marginal tax rates between the two years are different. IRC §1341 allows taxpayers to claim either a deduction or tax credit for the repayment in the year of repayment.

If the amount of repayment is $3,000 or less, it is deducted from income in the year of repayment. If it must be deducted as a miscellaneous itemized deduction, it is subject to the 2% of AGI limitation.[46] However, it is possible the taxpayer may not get any tax benefit based on the 2% threshold if they do not itemize deductions or are subject to the alternative minimum tax.

41. *Social Security Publishes New Rule Revising Withdrawal Policy.* SSA Press Office. [www.socialsecurity.gov/pressoffice/pr/withdrawal-policy-pr.html] Accessed on Jul. 8, 2011.

42. Social Security Administration, 20 CFR Part 404, RIN 0960-AH07, *Amendments to Regulations Regarding Withdrawal of Applications and Voluntary Suspension of Benefits,* as published in the Federal Register, Vol. 75, No. 235 (Dec. 8, 2010).

43. *North American Oil Consolidated v. Comm'r,* 286 U.S. 417 (1932).

44. *Smarthealth Inc. v. Comm'r,* TC Memo 2001-145 (Jun. 20, 2001).

45. IRS Pub. 525, *Taxable and Nontaxable Income.*

46. Ibid.

If the amount of the repayment exceeds $3,000, the taxpayer has two options available and can use the option that results in the lowest tax.[47]

1. They can compute the tax claiming a deduction for the repaid amount. If the amount must be deducted as a miscellaneous itemized deduction, it is **not** subject to the 2% of AGI limitation; or
2. They can recompute the tax for the earlier year as if the income was reduced by the amount of repayment and take the difference as a tax credit on the current year return.

These repayment rules do not apply to:[48]

1. Deductions for sales to customers, such as returns and allowances;
2. Deductions for theft losses due to fraud or embezzlement;
3. Legal fees that are a result of contesting the repayment of income; or
4. Bad debts.

### Claim of Right Doctrine and Repayment of Social Security Benefits

For repayments of social security benefits, IRC §1341 applies if the amount in box 5 (net benefits) of SSA-1099 is a negative amount (i.e., the total benefits repaid are more than the gross benefits received). On a joint return, if one spouse has a negative amount of benefits in box 5 for the year and the other a positive amount, the amounts are combined when figuring whether the benefits are taxable.

If the total amount shown in box 5 of all the taxpayer's Forms SSA-1099 is a negative figure, the taxpayer can take an itemized deduction for the part of this negative figure that represents benefits they included in gross income in an earlier year.[49]

If the deduction is $3,000 or less, it is reported as a miscellaneous itemized deduction subject to the 2% of AGI limitation.

If the deduction is more than $3,000, the tax should be calculated in one of two ways.[50]

**Method 1.** Calculate the tax for the current year with the itemized deduction included on Schedule A, line 28 (other miscellaneous deductions).

**Method 2.** Calculate the tax for the current year using the following steps.

- **a.** Calculate the tax without the itemized deduction included on Schedule A, line 28.
- **b.** Recompute the taxable benefits for each year after 1983 that represents a repayment of benefits as if the total benefits for the year were reduced by the benefits repaid. Then recalculate the tax for that year.
- **c.** Subtract the tax calculated in (b) from the total of the actual tax amounts.
- **d.** Subtract the result in (c) from the result in (a).

The tax for the current year is the smaller of the two amounts. If Method 1 results in less tax, the itemized deduction is reported on Schedule A, line 28. If Method 2 results in less tax, the taxpayer should claim a credit for the amount from Method 2, Step (c) on Form 1040, line 71, and write "IRC 1341" to the left of line 71. If both methods produce the same result, the taxpayer should deduct the repayment on Schedule A, line 28.

---

47. Ibid.
48. Ibid.
49. IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits.*
50. Ibid.

**Example 29.** In 2010, Marvin collected $12,500 of social security benefits. His other income caused 85% of the benefits to be taxable ($10,625), and he was in the 25% federal income tax bracket.

In 2011, Marvin discontinued receiving social security benefits and was required to repay $6,250. Marvin's 2011 tax bracket is 25% and he itemizes deductions.

Because the repayment is greater than $3,000, Marvin has the option of either taking a deduction not subject to the 2% threshold on Schedule A of his 2011 tax return, or taking a tax credit on his 2011 return based on a recomputation of his 2010 tax liability.

Assuming his tax bracket did not change in either year as a result of claiming a tax credit or deduction, his tax benefit under §1341 is calculated as follows.

**Method 1.** Because 85% of Marvin's benefits were taxable in 2010, his deduction on his 2011 return is $5,313 ($6,250 × 85%). At a marginal tax rate of 25%, this produces a tax benefit of $1,328 (25% × $5,313).

**Method 2.** Recompute his 2010 tax liability and net the repayment against the income reported that year, or $6,250 ($12,500 − $6,250) subject to tax. Because 85% of Marvin's 2010 benefits were taxable, this results in a tax benefit of $1,328 ($6,250 × 85% × 25% tax rate).

Because Marvin derives the same tax benefit from both methods, he deducts the repayment on Schedule A, line 28.

## For Example 29

**SCHEDULE A (Form 1040)**
Department of the Treasury
Internal Revenue Service (99)

# Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedule A (Form 1040).

OMB No. 1545-0074
2011
Attachment Sequence No. 07

Name(s) shown on Form 1040: **Marvin**
Your social security number: **123-45-6789**



| | | | | | |
|---|---|---|---|---|---|
| **Medical and Dental Expenses** | | **Caution.** Do not include expenses reimbursed or paid by others. | | | |
| | 1 | Medical and dental expenses (see instructions) | 1 | | |
| | 2 | Enter amount from Form 1040, line 38 \| 2 \| | | | |
| | 3 | Multiply line 2 by 7.5% (.075) | 3 | | |
| | 4 | Subtract line 3 from line 1. If line 3 is more than line 1, enter -0- | | 4 | |
| **Taxes You Paid** | 5 | State and local **(check only one box):** | | | |
| | | a ☐ Income taxes, **or** | 5 | | |
| | | b ☐ General sales taxes | | | |
| | 6 | Real estate taxes (see instructions) | 6 | | |
| | 7 | Personal property taxes | 7 | | |
| | 8 | Other taxes. List type and amount ▶ | 8 | | |
| | 9 | Add lines 5 through 8 | | 9 | |
| **Interest You Paid** | 10 | Home mortgage interest and points reported to you on Form 1098 | 10 | | |
| **Note.** Your mortgage interest deduction may be limited (see instructions). | 11 | Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶ | 11 | | |
| | 12 | Points not reported to you on Form 1098. See instructions for special rules | 12 | | |
| | 13 | Mortgage insurance premiums (see instructions) | 13 | | |
| | 14 | Investment interest. Attach Form 4952 if required. (See instructions.) | 14 | | |
| | 15 | Add lines 10 through 14 | | 15 | |
| **Gifts to Charity** | 16 | Gifts by cash or check. If you made any gift of $250 or more, see instructions | 16 | | |
| If you made a gift and got a benefit for it, see instructions. | 17 | Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500 | 17 | | |
| | 18 | Carryover from prior year | 18 | | |
| | 19 | Add lines 16 through 18 | | 19 | |
| **Casualty and Theft Losses** | 20 | Casualty or theft loss(es). Attach Form 4684. (See instructions.) | | 20 | |
| **Job Expenses and Certain Miscellaneous Deductions** | 21 | Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶ | 21 | | |
| | 22 | Tax preparation fees | 22 | | |
| | 23 | Other expenses—investment, safe deposit box, etc. List type and amount ▶ | 23 | | |
| | 24 | Add lines 21 through 23 | 24 | | |
| | 25 | Enter amount from Form 1040, line 38 \| 25 \| | | | |
| | 26 | Multiply line 25 by 2% (.02) | 26 | | |
| | 27 | Subtract line 26 from line 24. If line 26 is more than line 24, enter -0- | | 27 | |
| **Other Miscellaneous Deductions** | 28 | Other—from list in instructions. List type and amount ▶ **IRC §1341 ADJUSTMENT $5,313** | | 28 | 5,313 |
| **Total Itemized Deductions** | 29 | Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40 | | 29 | |
| | 30 | If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐ | | | |

**For Paperwork Reduction Act Notice, see Form 1040 instructions.** Cat. No. 17145C **Schedule A (Form 1040) 2011**