Chapter 3: Individual Taxpayer Topics

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Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

EIC DUE DILIGENCE

REQUIREMENTS

According to the IRS, there are a significant number of ineligible individuals claiming the earned income credit (EIC) and the amount of the EIC is overstated. The IRS "estimates an error rate of 21% to 26%, or $15 billion paid out in error in 2011."[1] In an effort to reduce error rates, the IRS implemented due diligence requirements for all tax return **preparers.**

A "tax return preparer" refers to any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any tax return or claim for refund. The preparation of a **substantial portion** of a return or claim for refund is treated as the preparation of a return or claim for refund.[2]

The EIC due diligence requirements require the tax return preparer to complete Form 8867, *Paid Preparer's Earned Income Credit Checklist,* for every return prepared claiming the EIC.[3] The preparer must have no knowledge that information furnished is incorrect and must make reasonable inquiries when information furnished appears to be incorrect, inconsistent, or incomplete. They must also keep due diligence information on file for three years.[4]

EIC DUE DILIGENCE PENALTY

A tax return preparer who fails to comply with the EIC due diligence requirements can be penalized $500 for each failure.[5] This penalty may be imposed in addition to any other applicable penalty.[6] For these reasons, tax return preparers should refuse to prepare a return if, after exercising due diligence, the preparer is not satisfied that the return is correct.

There is no reasonable cause exception to the penalty for failing to comply with the EIC due diligence requirements. However, a return preparer is only required to make "reasonable inquiries" if the information "appears" to be incorrect, inconsistent, or incomplete.[7]

Observation. It is likely that the conduct of the tax return preparer will be compared to the conduct of an ordinary, prudent return preparer under like circumstances.

1. *About EITC for Preparers.* Jun. 19, 2012. [www.eitc.irs.gov/rptoolkit/abouteitcforpreparers] Accessed on Jun. 26, 2012.
2. IRC §7701(a)(36)(A).
3. Treas. Reg. §1.6695-2(b).
4. Treas. Reg. §1.6695-2(b)(4).
5. The penalty increased from $100 to $500 for all returns prepared after December 31, 2011.
6. IRC §6696(a).
7. Treas. Reg. §1.6695-2(b)(3)(i).

The statute of limitations for failing to comply with the EIC due diligence requirements is three years after the date the return or claim for refund was filed.[8]

> **Note.** All preparers are held to the ethical standards defined in Circular 230 and are subject to consequences if the standards are not met, including the due diligence standard. For more information, see 2012 Volume A, Chapter 2: Ethics.

REQUIREMENTS FOR CLAIMING THE EIC

All taxpayers claiming the EIC must meet the following requirements.

1. Possess a valid social security number
2. Have earned income
3. Not file as married filing separately
4. Not file Form 2555, *Foreign Earned Income,* or Form 2555-EZ, *Foreign Earned Income Exclusion*
5. Not have investment income of $3,200 or more for the year
6. Not be the qualifying child of another person
7. Generally, be a U.S. citizen or resident alien for the entire year

The taxpayer must also meet **one** of the following two tests.

1. Have a qualifying child that meets all the following tests
   - a. Age
     - i. The child must be under 19 at the end of the year or under 24 and a student, or
     - ii. The child may be any age if they are permanently and totally disabled.
   - b. Relationship
     - i. The child must be a son, daughter, stepchild, foster child, or a descendant of any of them; or
     - ii. A brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them.
   - c. Residency — The child must live with the taxpayer in the United States for more than half the year in which the credit is claimed.
   - d. Joint return — The child may not file a joint return in the same year or may file one for the sole purpose of claiming a refund.
2. Meet **all** of the following requirements
   - a. Have lived in the United States for more than half the year
   - b. Be at least age 25 but younger than age 65
   - c. Not qualify as a dependent of another person

> **Note.** If the taxpayer had any EIC claim after 1996 denied for more than a math or clerical error, the taxpayer may not be able to claim the EIC for a period of years. If the error was due to reckless or intentional disregard of the EIC rules, the EIC cannot be claimed for the next two years. If the error was due to fraud, the EIC cannot be claimed for the next 10 years.

8. IRC §6696(d).

Form 8867

All tax return preparers must complete a Form 8867, *Paid Preparer's Earned Income Credit Checklist,* for all tax returns they prepare in which the EIC is claimed. The form assists the preparer in addressing all the requirements for claiming the EIC. Form 8867 and additional documentation regarding the due diligence inquiries must be kept for at least three years from the time the return claiming the EIC is filed.[9]

A completed Form 8867 and the accompanying instructions are provided with **Example 1** later in this chapter.

Note. For more information regarding the EIC requirements, see pages 125–129 in the 2011 *University of Illinois Federal Tax Fundamentals* workbook.

Trade or Business Income

Paid tax return preparers have additional EIC due diligence requirements to ensure self-employment (SE) income used in calculating eligibility for the EIC is correct and complete. Additional inquiries made by the tax return preparer and the client's responses must be documented.

Some taxpayers erroneously think they can report an incorrect amount of net SE income to qualify for or maximize the amount of EIC.

The preparer is required to ask sufficient questions of clients claiming SE income to ensure that the client is actually conducting a business, has records to support income and expenses or can reasonably reconstruct income and expense records, and has included all income and related expenses.

Handling the Most Common Errors

The IRS estimates that approximately 60% of the errors in preparing returns claiming the EIC are due to the following issues.[10]

1. Claiming a child who does not meet qualifying child requirements
2. Using an incorrect filing status
3. Under- or over-reporting income and expenses

The tax return preparer must meet the due diligence requirements in substantiating EIC claims. This sometimes requires the preparer to ask probing questions of the taxpayer to gather documentation for the claim. Form 886-H-EIC, *Documents You Need to Prove You Can Claim an Earned Income Credit on the Basis of a Qualifying Child or Children,* may assist the preparer in reviewing the legal requirements for the claim with the taxpayer. It also provides more information to the taxpayer about why the preparer may be asking specific questions.

Claiming a Child Who Is Not a Qualifying Child. The following questions may help substantiate a claim that appears inconsistent.

- Is the child a foster child or adopted?
- Was the child placed in the taxpayer's home for adoption or as a foster child?
- Was the taxpayer ever married to the child's other parent?
- Does the child's other parent reside with the taxpayer?
- How long have the children lived with the taxpayer?
- Are there any school or doctor records to document the time the children have lived with the taxpayer?

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9. Treas. Reg. §1.6695-2(b)(4).

10. *Handling the Most Common Errors.* [www.eitc.irs.gov/rptoolkit/toolsandtips/mostcommonerrors] Accessed on Jun. 26, 2012.

> **Note.** It is important for the tax return preparer to document the questions asked and responses received, in addition to collecting documentation provided to substantiate the claims. This is part of the preparer's due diligence recordkeeping requirement.

Using an Incorrect Filing Status. Many of the errors in this area arise when a **married taxpayer** incorrectly claims the head of household (HoH) filing status.[11] Asking the following questions may help the preparer ensure that the taxpayer is eligible to claim HoH status.

- Has the taxpayer ever been married?
- If the taxpayer is still married, when did the taxpayer and spouse separate?
- Does the taxpayer reside apart from their spouse and when did this change occur?
- Did the taxpayer's child live with the taxpayer for more than half of the year?
- Did anyone besides the child reside with the taxpayer?

To qualify as HoH, the taxpayer must pay more than half the costs of maintaining a home. Records pertaining to the following costs may help document that more than half the living expenses were paid by the taxpayer.

- Property taxes
- Mortgage payments
- Rent
- Utilities
- Household upkeep and repairs
- Property insurance
- Food consumed at home

> **Caution.** An **unmarried** taxpayer does not have to qualify as HoH to claim the EIC. In comparison, **married** taxpayers who do not file jointly with their spouses must file as MFS or HoH, and the EIC may not be claimed by a taxpayer filing MFS.

Under- or Over-Reporting Income and Expenses. As mentioned earlier in this section, some taxpayers may claim undocumented SE income. Additional questions should be asked and documentation requested to support the computation of their income. These inquiries may also be helpful in addressing a return with Schedule C, Schedule F, or pass-through SE issues.

- Does the taxpayer have any records to document the amount of money they received from self employment?
- How much does the taxpayer charge for their services?
- How many clients does the taxpayer have?
- Does the taxpayer pay for the supplies necessary for the service or work performed? If so, are there any records of these payments?
- Are there any additional costs incurred by the taxpayer? If so, are there any records or receipts for these expenses?

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11. The requirements for the HoH status are discussed later in this chapter.

A few of the issues that may lead to erroneous EIC computations include the following.

- Claiming personal expenses as business deductions
- Understating or overstating gross receipts
- Handwritten Forms 1099
- Improper identification of qualified dependents
- Claiming deductible losses that should be limited

A few of the issues that may lead to appropriate EIC computations include the following.

- Use of §179 deductions
- Use of bonus depreciation
- HSA deductions
- IRA and other retirement deductions
- Claiming the tuition and fees deduction instead of a tax credit

Example 1. Fred Smith is preparing a tax return for Cindy Lou. Cindy Lou has two qualifying children and claims to have a Schedule C business. Cindy Lou wants to claim the EIC. She says she earned $10,000 from her Schedule C business, but she has no expenses. Fred completes the following Form 8867 but needs to make further inquiries regarding the correctness of the information. Fred should recognize that it is unlikely that someone who is self-employed would have no business expenses. The information provided by Cindy Lou regarding the income and expenses appears to be incomplete or incorrect.

For Example 1

Form **8867** | **Paid Preparer's Earned Income Credit Checklist** | OMB No. 1545-1629

Department of the Treasury
Internal Revenue Service

► To be completed by preparer and filed with Form 1040, 1040A, or 1040EZ.
► Information about Form 8867 and its separate instructions is at *www.irs.gov/form8867*.

2012 Attachment Sequence No. **177**

Taxpayer name(s) shown on return	Taxpayer's social security number
Cindy Lou	111-11-1111

For the definitions of the following terms, see **Pub. 596**.

- **Investment Income**
- **Qualifying Child**
- **Earned Income**
- **Full-time Student**

Part I All Taxpayers

1 Enter preparer's name and PTIN ► Fred Smith P00011111

2 Is the taxpayer's filing status married filing separately? . . . . ☐ Yes ☒ No

► If you checked **"Yes"** on line 2, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

3 Does the taxpayer (and the taxpayer's spouse if filing jointly) have a social security number (SSN) that allows him or her to work or is valid for EIC purposes? See the instructions before answering ☒ Yes ☐ No

► If you checked **"No"** on line 3, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

4 Is the taxpayer filing Form 2555 or Form 2555-EZ (relating to the exclusion of foreign earned income)? . . . . ☐ Yes ☒ No

► If you checked **"Yes"** on line 4, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

5a Was the taxpayer a nonresident alien for any part of 2012? . . . . ☐ Yes ☒ No

► If you checked **"Yes"** on line 5a, go to line 5b. Otherwise, skip line 5b and go to line 6.

b Is the taxpayer's filing status married filing jointly? . . . . ☐ Yes ☒ No

► If you checked **"Yes"** on line 5a and **"No"** on line 5b, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

6 Is the taxpayer's **investment income** more than $3,200? See Rule 6 in Pub. 596 before answering ☐ Yes ☒ No

► If you checked **"Yes"** on line 6, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

7 Could the taxpayer, or the taxpayer's spouse if filing jointly, be a **qualifying child** of another person for 2012? If the taxpayer's filing status is married filing jointly, check "No." Otherwise, see Rule 10 (Rule 13 if the taxpayer does not have a qualifying child) in Pub. 596 before answering . . . . ☐ Yes ☒ No

► If you checked **"Yes"** on line 7, **stop;** the taxpayer **cannot** take the EIC. Otherwise, go to Part II or Part III, whichever applies.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 26142H Form **8867** (2012)

For Example 1

Line	**Part II** Taxpayers With a Child	Child 1	Child 2	Child 3
	Caution. If there is more than one child, complete lines 8 through 14 for one child before going to the next column.			
8	Child's name			
9	Is the child the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them?	☒ Yes ☐ No	☒ Yes ☐ No	☐ Yes ☐ No
10	Is either of the following true? • The child is unmarried, or • The child is married, can be claimed as the taxpayer's dependent, and is not filing a joint return (or is filing it only as a claim for refund).	☒ Yes ☐ No	☒ Yes ☐ No	☐ Yes ☐ No
11	Did the child live with the taxpayer in the United States for over half of the year? See the instructions before answering	☒ Yes ☐ No	☒ Yes ☐ No	☐ Yes ☐ No
12	Was the child (at the end of 2012)— • Under age 19 and younger than the taxpayer (or the taxpayer's spouse, if the taxpayer files jointly), • Under age 24, a full-time student, and younger than the taxpayer (or the taxpayer's spouse, if the taxpayer files jointly), or • Any age and permanently and totally disabled?	☒ Yes ☐ No	☒ Yes ☐ No	☐ Yes ☐ No
	▶ If you checked **"Yes"** on lines 9, 10, 11, **and** 12, the child is the taxpayer's qualifying child; go to line 13a. If you checked **"No"** on line 9, 10, 11, **or** 12, the child is not the taxpayer's qualifying child; see the instructions for line 12.			
13a	Could any other person check **"Yes"** on lines 9, 10, 11, **and** 12 for the child?	☐ Yes ☒ No	☐ Yes ☒ No	☐ Yes ☐ No
	▶ If you checked **"No"** on line 13a, go to line 14. Otherwise, go to line 13b.			
b	Enter the child's relationship to the other person(s)			
c	Under the tiebreaker rules, is the child treated as the taxpayer's qualifying child? See the instructions before answering	☐ Yes ☐ No ☐ Don't know	☐ Yes ☐ No ☐ Don't know	☐ Yes ☐ No ☐ Don't know
	▶ If you checked **"Yes"** on line 13c, go to line 14. If you checked **"No,"** the taxpayer **cannot** take the EIC based on this child and cannot take the EIC for taxpayers who do not have a qualifying child. If there is more than one child, see the **Note** at the bottom of this page. If you checked **"Don't know,"** explain to the taxpayer that, under the tiebreaker rules, the taxpayer's EIC and other tax benefits may be disallowed. Then, if the taxpayer wants to take the EIC based on this child, complete lines 14 and 15. If not, and there are no other qualifying children, the taxpayer cannot take the EIC, including the EIC for taxpayers without a qualifying child; do not complete Part III. If there is more than one child, see the **Note** at the bottom of this page.			
14	Does the qualifying child have an SSN that allows him or her to work or is valid for EIC purposes? See the instructions before answering	☒ Yes ☐ No	☒ Yes ☐ No	☐ Yes ☐ No
	▶ If you checked **"No"** on line 14, the taxpayer **cannot** take the EIC based on this child and cannot take the EIC available to taxpayers without a qualifying child. If there is more than one child, see the **Note** at the bottom of this page. If you checked "**Yes**" on line 14, continue.			
15	Are the taxpayer's **earned income** and **adjusted gross income** each less than the limit that applies to the taxpayer for 2012? See Pub. 596 for the limit			☐ Yes ☐ No
	▶ If you checked **"No"** on line 15, **stop;** the taxpayer **cannot** take the EIC. If you checked **"Yes"** on line 15, the taxpayer can take the EIC. Complete **Schedule EIC** and attach it to the taxpayer's return. If there are two or three qualifying children with valid SSNs, list them on Schedule EIC in the same order as they are listed here. If the taxpayer's EIC was reduced or disallowed for a year after 1996, see Pub. 596 to see if **Form 8862** must be filed. Go to line 20.			
	Note. If you checked **"No"** on line 13c or 14 but there is more than one child, complete lines 8 through 14 for the other child(ren) (but for no more than three qualifying children). Also do this if you checked **"Don't know"** on line 13c and the taxpayer is not taking the EIC based on this child.			

Form **8867** (2012)

For Example 1

Form 8867 (2012) Page 3

Part III Taxpayers Without a Qualifying Child

16	Was the taxpayer's main home, and the main home of the taxpayer's spouse if filing jointly, in the United States for more than half the year? (Military personnel on extended active duty outside the United States are considered to be living in the United States during that duty period. See Pub. 596.)	☐ Yes ☐ No
	▶ If you checked **"No"** on line 16, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.	
17	Was the taxpayer, or the taxpayer's spouse if filing jointly, at least age 25 but under age 65 at the end of 2012? See the instructions before answering	☐ Yes ☐ No
	▶ If you checked **"No"** on line 17, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.	
18	Is the taxpayer, or the taxpayer's spouse if filing jointly, eligible to be claimed as a dependent on anyone else's federal income tax return for 2012? If the taxpayer's filing status is married filing jointly, check "No"	☐ Yes ☐ No
	▶ If you checked **"Yes"** on line 18, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.	
19	Are the taxpayer's **earned income** and **adjusted gross income** each less than the limit that applies to the taxpayer for 2012? See Pub. 596 for the limit	☐ Yes ☐ No
	▶ If you checked **"No"** on line 19, **stop;** the taxpayer **cannot** take the EIC. If you checked **"Yes"** on line 19, the taxpayer can take the EIC. If the taxpayer's EIC was reduced or disallowed for a year after 1996, see Pub. 596 to find out if **Form 8862** must be filed. Go to line 20.	

Part IV Due Diligence Requirements

20	Did you complete Form 8867 based on current information provided by the taxpayer or reasonably obtained by you?	☒ Yes ☐ No
21	Did you complete the EIC worksheet found in the Form 1040, 1040A, or 1040EZ instructions (or your own worksheet that provides the same information as the 1040, 1040A, or 1040EZ worksheet)? . .	☒ Yes ☐ No
22	If any qualifying child was not the taxpayer's son or daughter, did you ask why the parents were not claiming the child and document the answer?	☐ Yes ☐ No ☒ Does not apply
23	If the answer to question 13a is "Yes" (indicating that the child lived for more than half the year with someone else who could claim the child for the EIC), did you explain the tiebreaker rules and possible consequences of another person claiming your client's qualifying child?	☐ Yes ☐ No ☒ Does not apply
24	Did you ask this taxpayer any additional questions that are necessary to meet your knowledge requirement? See the instructions before answering	☒ Yes ☐ No ☐ Does not apply
	To comply with the EIC knowledge requirement, you must not know or have reason to know that any information used to determine the taxpayer's eligibility for, and the amount of, the EIC is incorrect. You may not ignore the implications of information furnished to or known by you, and you must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent, or incomplete. At the time you make these inquiries, you must document in your files the inquiries you made and the taxpayer's responses.	
25	Did you document the additional questions you asked and your client's answers?	☒ Yes ☐ No ☐ Does not apply

Form **8867** (2012)

For Example 1

Form 8867 (2012) Page **4**

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26 Which documents below, if any, did you rely on to determine EIC eligibility for the qualifying child(ren) listed on Schedule EIC? Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no qualifying child, check box a. If there is no disabled child, check box o.

Residency of Qualifying Child(ren)

- ☐ **a** No qualifying child
- ☐ **b** School records or statement
- ☐ **c** Landlord or property management statement
- ☐ **d** Health care provider statement
- ☐ **e** Medical records
- ☐ **f** Child care provider records
- ☐ **g** Placement agency statement
- ☐ **h** Social service records or statement
- ☐ **i** Place of worship statement
- ☐ **j** Indian tribal official statement
- ☐ **k** Employer statement
- ☐ **l** Other (specify) ▼
- ☐ **m** Did not rely on any documents, but made notes in file
- ☐ **n** Did not rely on any documents

Disability of Qualifying Child(ren)

- ☐ **o** No disabled child
- ☐ **p** Doctor statement
- ☐ **q** Other health care provider statement
- ☐ **r** Social services agency or program statement
- ☐ **s** Other (specify) ▼
- ☐ **t** Did not rely on any documents, but made notes in file
- ☐ **u** Did not rely on any documents

27 If a Schedule C is included with this return, which documents or other information, if any, did you rely on to confirm the existence of the business and to figure the amount of Schedule C income and expenses reported on the return? Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no Schedule C, check box a.

Documents or Other Information

- ☐ **a** No Schedule C
- ☐ **b** Business license
- ☐ **c** Forms 1099
- ☐ **d** Records of gross receipts provided by taxpayer
- ☐ **e** Taxpayer summary of income
- ☐ **f** Records of expenses provided by taxpayer
- ☐ **g** Taxpayer summary of expenses
- ☐ **h** Bank statements
- ☐ **i** Reconstruction of income and expenses
- ☐ **j** Other (specify) ▼
- ☐ **k** Did not rely on any documents, but made notes in file
- ☐ **l** Did not rely on any documents

▶ You have complied with all the due diligence requirements if you:

1. Completed the actions described on lines 20 and 21 and checked **"Yes"** on those lines,
2. Completed the actions described on lines 22, 23, 24, and 25 (if they apply) and checked **"Yes"** (or **"Does not apply"**) on those lines,
3. Submit Form 8867 in the manner required, **and**
4. Keep all five of the following records for 3 years from the latest of the dates specified in the instructions under *Document Retention*:
   a. Form 8867, Paid Preparer's Earned Income Credit Checklist,
   b. The EIC worksheet(s) or your own worksheet(s),
   c. Copies of any taxpayer documents you relied on to determine eligibility for or amount of EIC,
   d. A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained, and
   e. A record of any additional questions you asked and your client's answers.

▶ If you checked **"No"** on line 20, 21, 22, 23, 24, or 25, you have not complied with all the due diligence requirements and may have to pay a $500 penalty for each failure to comply.

Form **8867** (2012)

Caution. In the 2012 draft of Form 8867 (shown above), the IRS has made substantial changes in Part IV that did not exist in the 2011 version. To properly complete Part IV, the tax preparer must make additional inquiries of the taxpayer to comply with the EIC due diligence requirements. In addition, the preparer must indicate the specific documentation requested and relied upon in the course of claiming the EIC for the taxpayer. Copies of the records relied upon must be retained by the tax preparer for three years.

> **Note.** The IRS established a website to address EIC questions and issues. For more detailed information on these and other potential errors, visit **www.eitc.irs.gov.** Additional information on the EIC can be found in 2012 Volume C, Chapter 2: Credits.

EIC IMPROVEMENTS

The taxpayer advocate service (TAS) identified improvements in the EIC as a priority issue for 2012. In a report to Congress, the TAS addressed some of the criticisms regarding "the relatively high level of 'improper payments' associated with the credit." The TAS recognized that, although some of the improper payments were the result of deliberate false claims, considerable noncompliance results from taxpayer difficulty in **substantiating** the claims to the satisfaction of the IRS. For 2012, the TAS will work to help increase EIC compliance.[12]

> **Note.** The statement to Congress by National Taxpayer Advocate Nina E. Olson points out that the IRS audit rate for returns with EIC claims is twice the rate of individual taxpayers without EIC claims. The EIC audits constitute approximately one-third of all audits. The TAS also demonstrates that the average yield for each audit is smaller in proportion to individual audits overall. Ms. Olson's complete written statement is available at **www.irs.gov/pub/irs-utl/testimony-written-wm_oversight-improper_payments-5-25-2011.pdf.**

On July 13, 2012, the IRS began sending letters to paid preparers who submitted tax year 2011 client returns claiming the EIC without attaching Form 8867. This letter is a warning for paid preparers because no penalties will be assessed for 2011 returns. Starting with 2012 tax returns, paid preparers will be subject to a due diligence penalty of $500 for each EIC return submitted without Form 8867.

The IRS Letter 4989 follows.

12. IRS News Rel. IR-2011-71 (Jun. 29, 2011).

Department of the Treasury
Internal Revenue Service
IRS
201 W Rivercenter Blvd.
Stop 825G
Covington KY 41011

Date:

Tax year:
2011

Contact telephone number:
1-866-860-4259

Why You Are Receiving This Letter
You submitted 2011 client returns claiming Earned Income Tax Credit (EITC) without attaching the Form 8867, *Paid Preparer's Earned Income Credit Checklist.*

Treasury Regulation §1.6695-2 was amended in late 2011. Paid return preparers must now complete and submit the Form 8867, *Paid Preparer's Earned Income Credit Checklist,* with every client return claiming EITC. Starting with tax year 2011, every EITC client return a preparer files electronically or by mail must have Form 8867 attached. In the case of a paper return presented to the client, the Form 8867 must be attached.

Consequences of Filing Tax Year 2012 EITC Returns Without Forms 8867
<u>If you do not submit the Form 8867 with tax year 2012 EITC client returns, your EITC due diligence requirements will not be met</u>. **You will be subject to a $500 penalty under Internal Revenue Code section 6695(g) for each EITC return submitted without Form 8867.** There is no maximum to the number of penalties that may be imposed.

Your failure to comply with these requirements may result in additional IRS actions, including revocation of your Authorized IRS *e-file* Provider status and your Registered Tax Return Preparer designation.

Required Action
Immediately begin attaching Form 8867 to the EITC returns that you prepare.

What to Do If You Need Help
Enclosed is a copy of Publication 4687, *EITC Due Diligence Brochure,* which provides guidance on EITC due diligence. Visit our EITC Preparer Toolkit at www.eitc.irs.gov/rptoolkit/main/ to learn more about your EITC due diligence requirements.

Sincerely,

Enclosure:
Publication 4687

Letter 4989 (6-2012)
Catalog Number 59586F

FINANCIAL DISTRESS

RECOURSE VERSUS NONRECOURSE DEBT

All debts can generally be categorized as **recourse or nonrecourse.** Either type of debt may be secured by collateral. However, in the event of a default on recourse debt, the borrower remains **personally liable.** If the recourse debt is a **full recourse debt,** the lender has the right to pursue legal action against any collateral for the loan pledged by the borrower and all of the borrower's other assets, which may be used to satisfy the loan obligation. If the loan is a **limited recourse debt,** the lender must rely on the terms of the original loan contract that may limit the lender's legal action to specific assets named in the contract. With a nonrecourse debt, the borrower is not personally liable in the event of a default. The lender's action against the nonrecourse borrower is limited to the collateral used to secure the loan. Whether a debt is recourse or nonrecourse and the particular rights a lender and borrower have with each type of debt is a matter of state law. States vary on the rules regarding these types of debts.

Generally, when debt for which the taxpayer is personally liable (recourse debt) is forgiven, the amount canceled must be included in income. If the taxpayer is not personally liable (nonrecourse debt), then there is no ordinary income from the cancellation of the debt. If the taxpayer retains the collateral and the lender either offers a discount for early payment or agrees to a debt modification resulting in the reduction of the principal, the taxpayer may have to report ordinary income.

> **Note.** If the canceled debt is business debt, the income is reported on the taxpayer's business schedule and is potentially subject to SE tax.[13]

Exceptions or Exclusions

There are several exceptions and exclusions that may result in nontaxable canceled debt. These include the following.

- Gifts
- Student loans canceled as a result of working for a certain type of employer or in a certain field
- Deductible debt
- Price reduced after purchase
- Pay-for-performance success payments under the Home Affordable Modification Program
- Title 11 bankruptcy
- Insolvency
- Qualified farm indebtedness
- Qualified real property business indebtedness
- Qualified principal residence indebtedness

When the taxpayer either has property foreclosed or repossessed or has recourse debt forgiven, the taxpayer should receive documentation from the lender to determine the tax implications from the event. The documentation issued depends on the type of debt and the type of event.

13. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments.*

WHEN IS FORM 1099-A ISSUED?

When a lender acquires an interest in the taxpayer's property either through a foreclosure or repossession, the lender issues Form 1099-A, *Acquisition or Abandonment of Secured Property,* to the taxpayer. This form provides the information necessary for the taxpayer to calculate the gain or loss.

The **abandonment** of property is a **disposition** of property. Abandonment occurs when the taxpayer **voluntarily and permanently** relinquishes possession and use of the property with the intention of ending ownership but without transferring the property to anyone else.

WHEN IS FORM 1099-C ISSUED?

When an entity cancels a debt of $600 or more, the creditor issues Form 1099-C, *Cancellation of Debt*. Box 2 shows the amount of debt canceled, and the recipient must report it as ordinary income. If interest is forgiven and included as canceled debt, the interest portion is listed in box 3. If the interest would normally be deductible, it does not have to be included in gross income. If the interest would not be deductible, the entire amount reported in box 2 should be included in gross income.

Cancellation for purposes of Form 1099-C occurs on the date that one of the following events occurs.[14]

- The debtor receives a discharge in bankruptcy under Title 11 for business or investment debt.
- The debt becomes unenforceable in a receivership, foreclosure, or similar court proceeding.
- The statute of limitations for collecting the debt expires.
- The creditor elects foreclosure remedies that, by law, end the creditor's right to collect.
- A cancellation or extinguishment makes the debt unenforceable under a probate or similar proceeding.
- There is a discharge of indebtedness under an agreement between the creditor and the debtor to cancel the debt at less than full value.
- There is a discharge of indebtedness because of a decision or a defined policy of the creditor to discontinue collection activity and cancel the debt.
- The 36-month nonpayment testing period expires. (This applies only to certain entities. See the Instructions for Forms 1099-A and 1099-C for more information.)

> **Note.** The issuance date and the cancellation date may not coincide. See *David and Carla Stewart v. Comm'r* in 2012 Volume B, Chapter 6: Rulings and Cases, for a recent related case.

When a lender cancels part of the debt for a property in foreclosure and is required to provide a Form 1099-C, the lender may choose to forgo issuing a Form 1099-A and, instead, provide only a Form 1099-C. In this situation, the lender must provide the necessary information regarding the gain or loss from the foreclosure or repossession on the Form 1099-C. Accordingly, a Form 1099-A is not required.

Even if the taxpayer does not receive Form 1099-C, the canceled debt must be reported as gross income on the tax return. The following transactions are not required to be reported on Form 1099-C.

- Cancellation of nonbusiness or noninvestment debts in bankruptcy
- The interest portion of canceled debt
- Nonprincipal amounts of canceled debt, including penalties, fines, fees, and administrative costs

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14. See the instructions for Forms 1099-A and 1099-C.

- Debt of a foreign debtor canceled by a foreign branch
- Transfers of debt between related debtors (not a cancellation)
- Release of a debtor from debt if other debtors are fully liable (not a cancellation)
- A demand for payment made to a guarantor
- A seller whose principal trade or business is the sale of nonfinancial goods or services extends credit to customers in connection with the purchase of those nonfinancial goods and services (not a required reporting entity)

Note. If the taxpayer is jointly and severally liable with another person for a debt that is canceled, both persons may receive a Form 1099-C showing the entire amount of canceled debt. The amount that must be reported depends on the state law and specific facts and circumstances of the parties' agreement (including interest deducted) and the basis of the co-owned property allocated to each co-owner.

Parties Required to Submit Form 1099-C

The following entities are required to file Forms 1099-C.

1. Certain federal government agencies
2. Financial institutions
3. Credit unions
4. Any organization for which lending money is a significant trade or business activity

MORTGAGE DEBT RELIEF ACT OF 2007

The Mortgage Debt Relief Act of 2007 allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief.

What the Act Covers

The Mortgage Debt Relief Act allows taxpayers to exclude income from the discharge of qualified debt on their principal residence. It applies to debt forgiven in calendar years 2007 through 2012. The taxpayer may exclude up to $2 million of forgiven debt, or $1 million if married filing separately. The exclusion applies only to debt forgiven due to a decline in the home's value or the taxpayer's financial condition. It does not apply if the discharge is due to services performed for the lender or any other reason.

Note. It is uncertain whether Congress will extend the Mortgage Debt Relief Act, which expires at the end of 2012. House Bill HR 4290 (the Homeowner Tax Fairness Act) was introduced to extend this law through 2015. This bill was assigned to a Congressional committee for consideration on March 28, 2012.

Principal Residence Qualifications

Only canceled debt used to buy, build, or improve the taxpayer's principal residence qualifies for relief. Debt used to refinance the taxpayer's principal residence qualifies for this exclusion but only to the extent that the principal balance of the old mortgage, immediately before the refinancing, would have qualified. Funds from refinancing that were used to pay credit card bills or for other purposes cannot be excluded from income as principal residence indebtedness but it may qualify for a different exclusion.

The amount of debt forgiven must be reported on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1017 Basis Adjustment),* and attached to the taxpayer's income tax return.

Example 2. Bob financed the purchase of his principal residence with recourse debt. The purchase price was \$880,000 and Bob financed \$800,000 through a mortgage with Powerful Bank. When the fair market value (FMV) of the home increased to \$1 million, Bob refinanced the debt for \$850,000. At that time, the original mortgage loan balance was \$740,000. Bob used the additional \$110,000 to buy the sailboat he had always dreamed of owning.

Two years later, Bob developed a severe allergic reaction to the chemicals in suntan lotion and he was unable to use his sailboat. This caused Bob to be severely depressed and he was no longer able to successfully make sales calls. As a result, he fell behind on his mortgage payments.

After the refinancing, the FMV of Bob's home fell to \$700,000. Powerful Bank agreed to a short sale on the home for \$675,000. The bank agreed to forgive the remaining balance of \$175,000 (\$850,000 − \$675,000).

Bob is able to exclude only \$65,000 (\$740,000 − \$675,000) of the canceled debt from his income as principal residence indebtedness. The remaining \$110,000 (\$175,000 − \$65,000) must be included as ordinary income on line 21 of Form 1040.

Bob's Forms 1099-C and 982 follow.

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, ZIP code, and telephone no. **Powerful Bank** **123 Mighty Way** **Kansas City, MO 46000**	1 Date canceled **07/01/2011** 2 Amount of debt canceled $ **175000.00** 3 Interest if included in box 2 $	OMB No. 1545-1424 **2011** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S federal identification number **12-3456789** DEBTOR'S identification number **555-66-7777**	4 Debt description **Mortgage on residence at** **14 Mockingbird Lane** **Kansas City, MO 46000**		**Copy B** **For Debtor** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name **Bob White** Street address (including apt. no.) **8600 Bird Lane** City, state, and ZIP code **Kansas City, MO 46000**	5 If checked, the debtor was personally liable for repayment of the debt . . . . ▶ ☑		
Account number (see instructions)	6 Bankruptcy (if checked) ☐	7 Fair market value of property $ **700000.00**	

Form **1099-C** (keep for your records) Department of the Treasury - Internal Revenue Service

Box 6 has been updated for 2012. Previously, Box 6 was designated for debt canceled through bankruptcy but now allows identification of other types of canceled debt. Providing a code other than for bankruptcy is optional. Identifiable codes can be found in the instructions for Form 1099-C.

Note. Lines 1e and 2 of Form 982 are completed if the taxpayer reports only the exclusion of qualified principal residence indebtedness forgiven as the result of a foreclosure. If the taxpayer retains ownership of the home and modification of the mortgage results in forgiveness of some qualified principal residence indebtedness, the taxpayer completes lines 1e, 2, and 10b of Form 982.

For Example 2

Form **982** (Rev. February 2011) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return	Identifying number
Bob White	555-66-7777

Part I **General Information** (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)		☐
c	Discharge of qualified farm indebtedness		☐
d	Discharge of qualified real property business indebtedness		☐
e	Discharge of qualified principal residence indebtedness		☒
2	Total amount of discharged indebtedness excluded from gross income	2	65,000
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge, including any capital loss carryovers to the tax year of the discharge	9	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10a	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10b	
11	For a discharge of qualified farm indebtedness applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5	11a	
b	Land used or held for use in a trade or business of farming	11b	
c	Other property used or held for use in a trade or business or for the production of income	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Part III **Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ ________________ from its gross income for the tax year beginning ________________ and ending ________________.
Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ________________.
(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

For Paperwork Reduction Act Notice, see page 5 of this form. Cat. No. 17066E Form **982** (Rev. 2-2011)

FORECLOSURE

> **Note.** Dispositions by foreclosure, short sale, or abandonment of a **principal residence** may result in a capital gain. Any capital gain realized from this type of disposition may qualify for exclusion from income under IRC §121.
>
> The amount of capital gain is equal to the "amount realized" less basis. The "amount realized" is defined differently for recourse and nonrecourse debts, as discussed in this section.

When the taxpayer fails to make payments on a loan that is secured by property, the lender may foreclose the loan or repossess the property. For tax purposes, this is treated as a **sale,** which can result in a gain or a loss.

Gain or Loss

If the loan balance was more than the FMV of the property and the remaining balance of the loan is canceled, there may be ordinary income from the cancellation of the debt that must be reported.

Gains or losses from foreclosures are reported the same way that a gain or loss from a sale is reported. A gain or loss is calculated by subtracting the taxpayer's adjusted basis from the amount realized.

> **Note.** For more information, see IRS Pub. 544, *Sales and Other Dispositions of Assets.*

For **recourse** debts, the **amount realized** includes the **smaller** of either the **FMV** of the transferred property or the **outstanding debt** immediately before the transfer. This amount is reduced by any amount for which the taxpayer remains personally liable. If any of the outstanding debt for which the taxpayer remains personally liable is canceled, it may create ordinary income that must be reported.

For **nonrecourse** debts, the amount realized includes the **full outstanding debt** immediately before the transfer.

> **Note.** Even if the FMV of the property is less than the outstanding debt, the full outstanding debt is the amount realized.

Exclusions from Income

As mentioned earlier, the Mortgage Debt Relief Act provides that canceled debt from the taxpayer's principal residence indebtedness can be excluded from income. However, it must be qualified principal residence indebtedness (QPRI).

> **Note.** If the taxpayer filed Chapter 11 bankruptcy and the debt was canceled as part of the bankruptcy, the taxpayer must apply the bankruptcy exclusion rather than the QPRI exclusion. If the taxpayer was insolvent immediately before the cancellation, the taxpayer may elect to take the insolvency exclusion instead. The taxpayer checks the box on line 1b of Form 982 rather than the box on line 1e. Insolvency is discussed in more detail later in this chapter.

> **Note.** If the taxpayer continues to own the home after the cancellation of QPRI, the taxpayer must reduce the basis in the home by the amount of QPRI excluded from income. This is reported on line 10b of Form 982. The reduced basis cannot be less than zero.

Example 3. Bachelor Barney purchased a house in Allen Township in 2007 for $200,000. He made a 20% down payment and financed the remaining $160,000 with State Bank. In 2010, Barney met Juanita and began spending lavishly on meals at the diner where she works. By 2011, Barney was far behind on his mortgage payments (and 20 pounds overweight). The bank foreclosed on his property. By this time, Allen Township experienced a significant decline in population and the housing values plummeted. Barney's house was worth only $120,000. Barney still owed State Bank $150,000 on the mortgage.

The president of State Bank is a regular customer of the diner. Juanita feels partly responsible for Barney's financial straits, and she is able to convince the bank president to forgive half of the debt in excess of the FMV of the house. Barney is personally responsible for the remaining $15,000. He receives a Form 1099-C that shows the forgiven debt of $15,000. His tax adviser also completes the following worksheet that shows the loss from the foreclosure.

Table 1-1. **Worksheet for Foreclosures and Repossessions**

Keep for Your Records

Part 1. Complete Part 1 only if you were personally liable for the debt (even if none of the debt was canceled). Otherwise, go to Part 2.	
1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	**135,000**
2. Enter the fair market value of the transferred property	**120,000**
3. **Ordinary income from the cancellation of debt upon foreclosure or repossession.*** Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	**15,000**
Part 2. Gain or loss from foreclosure or repossession.	
4. Enter the **smaller** of line 1 or line 2. If you did not complete Part 1 (because you were not personally liable for the debt), enter the amount of outstanding debt immediately before the transfer of property	**120,000**
5. Enter any proceeds you received from the foreclosure sale	**0**
6. Add line 4 and line 5	**120,000**
7. Enter the adjusted basis of the transferred property	**200,000**
8. **Gain or loss from foreclosure or repossession.** Subtract line 7 from line 6	**(80,000)**
* The income may not be taxable. See chapter 1 for more details.	

Based on the facts presented, the amount on line 3 ($15,000) is reported on Form 982 and the box on line 1e (discharge of QPRI) is checked. The amount on line 8 ($80,000 loss) is a nondeductible personal loss.

SHORT SALE

A "short sale" is a common term referring to a homeowner selling a house for less than the existing mortgage balance. The seller then requests that the lender forgive the remaining unpaid mortgage balance. The lender receives the entire sale price for the home in return for forgiving the difference between the mortgage and the sale price.

> **Note.** The IRS does not use the term "short sale" for this type of transaction or for real estate transactions.

Recourse versus Nonrecourse

A short sale is taxed in the same manner as a foreclosure. For recourse debt, if the debt is not fully satisfied by the surrender of the property, the debtor has cancellation of debt income in the amount of the remaining debt. The amount realized from the sale of the property does not include the discharge of indebtedness income.

Each of the two types of income resulting from the sale is treated separately. There is the taxable sale of the property, and the taxable discharge of indebtedness for the unpaid balance of the mortgage for which the taxpayer will receive a Form 1099-C.

Note. While a short sale is treated in the same way as a foreclosure when recourse debt is involved, a short sale may be preferable to the lender. If the taxpayer simply walks away from the property, the lender must prepare and sell the property, which could result in a larger loss than that proposed through the short sale process.

If the short sale involves nonrecourse debt and the seller and buyer require cancellation of the remaining debt as a condition of the sale, the amount of the debt canceled is included in the sale proceeds.

Note. If the sale involves a principal residence, the taxpayer may qualify to exclude from income the gain from the sale. This makes a short sale on a nonrecourse debt a viable alternative to foreclosure.

ABANDONMENT

A factual inquiry is required to determine whether property is considered abandoned. In order for property to be abandoned, the taxpayer must have voluntarily and permanently intended to give up possession of the property with no intention of recovering it. Also, the property must not have been transferred to another owner. There must be an intent to abandon followed by affirmative actions taken to further this goal.

Transferring the property in lieu of foreclosure is not an abandonment of the property. For tax purposes, the transfer is treated as an exchange of property to satisfy a debt.

Tax Consequences

The tax consequences of abandonment depend on whether the debt is recourse or nonrecourse debt. If the taxpayer abandons property that is security for a debt for which the taxpayer is personally liable, the gain or loss on the property cannot be computed until a sale of the property is completed.

Any debt canceled for which the taxpayer is personally liable is treated as ordinary income and is taxable. This amount is separate from the amount realized on the sale of the abandoned property.

The lender generally issues Form 1099-A, which provides information for the taxpayer to determine the gain or loss on the abandoned property. If the lender also cancels debt for which the taxpayer is personally liable, the lender issues a Form 1099-C showing the ordinary income realized from the cancellation. The lender can choose to incorporate the information required on Form 1099-A into Form 1099-C, as described earlier in this chapter, rather than submitting both forms to the taxpayer.

For tax purposes, abandoned property that is security for a debt for which the taxpayer is not personally liable is treated as a sale or exchange. The amount realized on the sale of the property minus its adjusted basis results in either a gain or a loss. Losses from a principal residence or other personal property are not deductible. For business or investment property, the loss is deductible and the character of the property determines how the loss is characterized.

Note. For more information, see IRS Pub. 544, *Sales and Other Dispositions of Assets*.

INSOLVENCY

When the taxpayer is insolvent immediately before the debt is canceled, the canceled debt may be excluded from income. A taxpayer is insolvent immediately before the cancellation if the total of all their liabilities is more than the FMV of all their assets at that time.

> **Note.** The taxpayer can elect to apply the insolvency exclusion instead of the QPRI exclusion. This might be more advantageous to taxpayers who qualify as insolvent and who previously refinanced their mortgage to pay debts unrelated to the principal residence.

For the purpose of determining whether the taxpayer is insolvent, assets include the value of everything the taxpayer owns. This includes assets that are collateral for the debt as well as assets that are exempt under state law and are beyond the reach of creditors. Interest in a pension plan or retirement account is also included in the determination of total assets.

Liabilities used in determining insolvency include the following.[15]

- The entire amount of recourse debt
- The amount of nonrecourse debt that is not in excess of the FMV of property used as security for the debt
- The amount of **forgiven** nonrecourse debt in excess of the FMV of the secured property

> **Note.** To claim the exclusion, the taxpayer checks the box on line 1b of Form 982. On line 2, the taxpayer enters the smaller of the amount of debt canceled or the amount by which the taxpayer was insolvent immediately before the cancellation.

Example 4. Ivana had $5,000 in credit card debt canceled. Big Credit Card Company sent her a Form 1099-C to report the amount of cancellation of debt income. Ivana only qualifies for the insolvency exception to the general rule that canceled debt is included as income.

Her total liabilities before the cancellation were $20,000. The FMV of her assets was only $10,000. Because Ivana's assets were $10,000 less than her liabilities, she was insolvent in the amount of $10,000. Ivana was insolvent in an amount greater than the canceled credit card debt, so she can exclude the entire $5,000 from income. Ivana checks the box on line 1b of Form 982. On line 2, she enters the $5,000 canceled debt because it is less than the amount by which she is insolvent. Ivana does not include the $5,000 as income on her Form 1040.

Form **982**
(Rev. February 2011)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ **Attach this form to your income tax return.**

OMB No. 1545-0046
Attachment Sequence No. **94**

Name shown on return	Identifying number
Ivana	222-22-2222

Part I **General Information** (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)		☑
c	Discharge of qualified farm indebtedness		☐
d	Discharge of qualified real property business indebtedness		☐
e	Discharge of qualified principal residence indebtedness		☐
2	Total amount of discharged indebtedness excluded from gross income	**2**	**5,000**
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☑ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in

15. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments.*

Example 5. Ivana's sister Marla also had credit card debt that was canceled. Marla received a Form 1099-C from Big Credit Card Company showing $7,500 of canceled debt. Marla only qualifies for the insolvency exception.

Marla's total liabilities before the cancellation were $12,500. The FMV of her assets was $11,000. Marla's liabilities were $1,500 ($12,500 − $11,000) greater than her assets, so she is insolvent in the amount of $1,500. The amount of Marla's canceled debt from Big Credit Card Company is more than the amount by which Marla is insolvent; therefore, she can only exclude $1,500 of the $7,500 canceled debt from income. Marla checks the box on line 1b of Form 982. On line 2, she enters $1,500 because her insolvency is less than the amount of debt canceled. Marla reports the remaining $6,000 in canceled debt as income on line 21 (other income) of Form 1040.

Form **982** (Rev. February 2011) Department of the Treasury Internal Revenue Service	**Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)** ▶ Attach this form to your income tax return.	OMB No. 1545-0046 Attachment Sequence No. **94**
Name shown on return: **Marla**		**Identifying number** 333-33-3333

Part I **General Information** (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)		☑
c	Discharge of qualified farm indebtedness		☐
d	Discharge of qualified real property business indebtedness		☐
e	Discharge of qualified principal residence indebtedness		☐
2	Total amount of discharged indebtedness excluded from gross income	2	1,500
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☑ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in

Example 6. Bob from **Example 2** was able to exclude only $65,000 of his $175,000 of debt forgiveness by utilizing the QPRI exclusion. The amount of debt forgiveness attributable to QPRI reduced the basis of Bob's home, which was treated as sold in 2011.

After making the $65,000 adjustment, Bob still had $110,000 of debt forgiveness. Unless Bob qualified for one of the other exclusion provisions, he would have had ordinary taxable income of $110,000.

However, after completing an insolvency worksheet, it was determined that Bob was insolvent before the debt cancellation by $40,000 ($920,000 in total assets – $960,000 in total liabilities). Bob excluded this $40,000 from income. The remaining $70,000 of debt forgiveness ($110,000 – $40,000) was taxed as ordinary income and reported on line 21 of Bob's 2011 Form 1040.

The regulations also required Bob to reduce tax attributes by the amount of debt excluded from income **after calculating his total tax liability for the year of cancellation.**[16] At the beginning of 2011, Bob had a long-term capital loss carryover of $72,500. Bob reduced the carryover of this tax attribute to 2012 by the $40,000 of excluded debt forgiveness.

Using both provisions, Bob was able to exclude $105,000 from income ($65,000 using the QPRI exclusion plus $40,000 using the insolvency exception). The following Form 982 includes both exclusions. The worksheet following the form shows how his adjusted long-term capital loss carryover to 2012 was calculated.

16. Treas. Reg. §1.108-7(b).

For Example 6

Form **982** (Rev. February 2011) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.

OMB No. 1545-0046
Attachment Sequence No. **94**

Name shown on return	Identifying number
Bob White	555-66-7777

Part I **General Information** (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)	$40,000	☒
c	Discharge of qualified farm indebtedness		☐
d	Discharge of qualified real property business indebtedness		☐
e	Discharge of qualified principal residence indebtedness	$65,000	☒
2	Total amount of discharged indebtedness excluded from gross income	2	105,000
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge, including any capital loss carryovers to the tax year of the discharge	9	40,000
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10a	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10b	
11	For a discharge of qualified farm indebtedness applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5	11a	
b	Land used or held for use in a trade or business of farming	11b	
c	Other property used or held for use in a trade or business or for the production of income	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Part III **Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ ______________ from its gross income for the tax year beginning ______________ and ending ______________ . Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ______________ .
(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

For Paperwork Reduction Act Notice, see page 5 of this form. Cat. No. 17066E Form **982** (Rev. 2-2011)

Bob's only source of 2011 income was the $70,000 of debt forgiveness that could not be excluded. Line 1 of the Capital Loss Carryover Worksheet was calculated as follows.

Debt forgiveness income	$70,000
Allowed portion of long-term capital loss carried over from 2010 and used in 2011	(3,000)
2011 standard deduction	(5,800)
Line 1 of worksheet below	$61,200

Capital Loss Carryover Worksheet - Lines 6 and 14

(Keep for your records)

Name	Social Security Number
Bob White	555-66-7777

1.	Enter the amount from your 2011 Form 1040, line 41, or your 2011 Form 1040NR, line 39. If a loss, enclose the amount in parentheses	1.	61,200
2.	Enter the loss from your 2011 Schedule D, line 21, as a positive amount	2.	3,000
3.	Combine lines 1 and 2. If zero or less, enter -0-	3.	64,200
4.	Enter the **smaller** of line 2 or line 3	4.	3,000
	If line 7 of your 2011 Schedule D is a loss, go to line 5; otherwise, enter -0- on line 5 and go to line 9.		
5.	Enter the loss from your 2011 Schedule D, line 7, as a positive amount	5.	
6.	Enter any gain from your 2011 Schedule D, line 15. If a loss, enter -0- 6. 0		
7.	Add lines 4 and 6	7.	
8.	**Short-term capital loss carryover for 2012.** Subtract line 7 from line 5. If zero or less, enter -0-. If more than zero, also enter this amount on Schedule D, line 6	8.	
	If line 15 of your 2011 Schedule D is a loss, go to line 9; otherwise, skip lines 9 through 13.		
9.	Enter the loss from your 2011 Schedule D, line 15, as a positive amount	9.	72,500
10.	Enter any gain from your 2011 Schedule D, line 7. If a loss, enter -0- . . . . . 10.		
11.	Subtract line 5 from line 4. If zero or less, enter -0- 11. 3,000		
12.	Add lines 10 and 11	12.	3,000
13.	**Long-term capital loss carryover for 2012.** Subtract line 12 from line 9. If zero or less, enter -0-. If more than zero, also enter this amount on Schedule D, line 14	13.	69,500

Adjustment to carryover by income excluded under the insolvency exception	**($40,000)**
Adjusted long-term capital loss carryover for 2012	**$29,500**

Caution. In many tax preparation software programs, the capital loss carryover must be manually adjusted as shown above.

Insolvency Worksheet

IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments,* provides the following insolvency worksheet to assist the taxpayer in determining whether they were insolvent immediately before the debt was canceled. IRS Pub. 4681 also contains a number of detailed examples with filled-in forms.

Insolvency Worksheet

Keep for Your Records

Date debt was canceled (mm/dd/yy)		
Part I. Total liabilities immediately before the cancellation (do not include the same liability in more than one category)		
	Liabilities (debts)	**Amount Owed Immediately Before the Cancellation**
1.	Credit card debt	$
2.	Mortgage(s) on real property (including first and second mortgages and home equity loans) (mortgage(s) can be on personal residence, any additional residence, or property held for investment or used in a trade or business)	$
3.	Car and other vehicle loans	$
4.	Medical bills owed	$
5.	Student loans	$
6.	Accrued or past-due mortgage interest	$
7.	Accrued or past-due real estate taxes	$
8.	Accrued or past-due utilities (water, gas, electric)	$
9.	Accrued or past-due child care costs	$
10.	Federal or state income taxes remaining due (for prior tax years)	$
11.	Judgments	$
12.	Business debts (including those owed as a sole proprietor or partner)	$
13.	Margin debt on stocks and other debt to purchase or secured by investment assets other than real property	$
14.	Other liabilities (debts) not included above	$
15.	**Total liabilities immediately before the cancellation. Add lines 1 through 14.**	$
Part II. Fair market value (FMV) of assets owned immediately before the cancellation (do not include the FMV of the same asset in more than one category)		
	Assets	**FMV Immediately Before the Cancellation**
16.	Cash and bank account balances	$
17.	Homes (including the value of land) (can be main home, any additional home, or property held for investment or used in a trade or business)	$
18.	Cars and other vehicles	$
19.	Computers	$
20.	Household goods and furnishings (for example, appliances, electronics, furniture, etc.)	$
21.	Tools	$
22.	Jewelry	$
23.	Clothing	$
24.	Books	$
25.	Stocks and bonds	$
26.	Investments in coins, stamps, paintings, or other collectibles	$
27.	Firearms, sports, photographic, and other hobby equipment	$
28.	Interest in retirement accounts (IRA accounts, 401(k) accounts, and other retirement accounts)	$
29.	Interest in a pension plan	$
30.	Interest in education accounts	$
31.	Cash value of life insurance	$
32.	Security deposits with landlords, utilities, and others	$
33.	Interests in partnerships	$
34.	Value of investment in a business	$
35.	Other investments (for example, annuity contracts, guaranteed investment contracts, mutual funds, commodity accounts, interests in hedge funds, and options)	$
36.	Other assets not included above	$
37.	**FMV of total assets immediately before the cancellation. Add lines 16 through 36.**	$
Part III. Insolvency		
38.	**Amount of Insolvency.** Subtract line 37 from line 15. If zero or less, you are not insolvent.	**$**

"CASH FOR KEYS"

When a home is foreclosed, the lender is responsible for maintaining the property and for any repairs or other issues. The process of foreclosure and eviction can take three to six months. During this period, there are legal costs in addition to potential damage done to the property by the vacating former homeowner, who has little incentive to maintain the property. "Cash for keys" is a program that some lenders are utilizing to reduce the time and costs involved in the transfer of property other than by eviction.

The lender may make a deal with a resident owner or a tenant to pay security and utility deposits, moving expenses, temporary living expenses, and a bonus for a quick moving date. In return, the lender receives the home keys, undamaged property fixtures and landscaping, and a relatively clean property that is ready for sale or rent.

The amount tendered is generally negotiable between the parties, but usually ranges from $500 up to $5,000. The amount provided depends on the property and other issues.

> **Note.** There are many state and federal laws regulating the notice required for tenants residing in homes subject to foreclosure. These laws should be reviewed for any clients who receive a "cash for keys" offer. See Protecting Tenants at Foreclosure Act, 7 USC §701.

Taxpayers that take advantage of "cash for keys" offers receive a Form 1099-MISC showing the amount paid. **This must be included as income on line 21 of Form 1040.**

REAL ESTATE PROFESSIONAL

Rental real estate activities are generally passive activities even if the taxpayer materially participates, unless the taxpayer qualifies as a real estate professional.

ELIGIBILITY

The taxpayer qualifies as a real estate professional for the year if the taxpayer meets both of the following requirements.

1. **50% Test.** More than half of the personal services performed in all trades or businesses during the tax year are performed in real property trades or businesses in which the taxpayer materially participates.
2. **750-Hour Test.** The taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates.[17]

> **Note.** Personal services performed as an employee in real property trades or businesses **do not** count toward the requirements unless the taxpayer is a 5% owner of the business.

> **Note.** Taxpayers who qualify as real estate professionals report income or losses from rental real estate activities as nonpassive income or losses by completing line 43 of Schedule E, *Supplemental Income and Loss.*

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17. IRC §469(c)(7)(B).

50% Test

Participation for the purpose of determining eligibility as a real estate professional is different than the test to determine material participation. **Participation** for a real estate professional is any work done in any capacity by the individual in connection with an activity in which the taxpayer owns an interest.[18]

A qualified real estate professional must perform more than half of their personal services during the tax year in real property trades or businesses. **Real property trades or businesses** include the following.[19]

- Real estate development
- Redevelopment
- Construction
- Reconstruction
- Acquisition
- Conversion
- Rental
- Leasing
- Operation
- Management
- Brokerage

750-Hour Test

The taxpayer must perform more than 750 hours of services during the tax year in one or more of the above-referenced real property trades or businesses. The taxpayer can meet this requirement by providing any combination of services as long as the total time spent exceeds 750 hours.

Closely Held Corporations

A closely held corporation can qualify as a real estate professional if more than 50% of the gross receipts for its tax year are from real property trades or businesses in which it materially participates.[20]

Spouses

A spouse's personal services **do not** count in determining whether the taxpayer met the real estate professional requirements. However, the spouse's participation in an activity counts in determining whether the taxpayer materially participated.

> **Note.** The taxpayer should document participation in the activities in a reasonable manner. Contemporaneous daily time reports, logs, or other documents are not required if the extent of participation can be established by other means. The identification of services and the approximation of time spent on the services may be based on appointment books, calendars, or narrative summaries.[21]

18. IRC §§469(c)(7)(B) and (D).
19. IRC §469(c)(7)(C).
20. IRC §469(c)(7)(D)(i).
21. Temp. Treas. Reg. §1.469-5T(f)(4).

Material Participation

The real estate professional taxpayer must prove that they materially participated in the real estate rentals. To meet the material participation requirement, the taxpayer must meet at least one of the following requirements for the taxable year.[22]

1. The taxpayer participated in the activity for more than 500 hours during the year.

2. The taxpayer's participation in the activity for the current year constitutes substantially all of the participation of all individuals. A 1-person operation is generally regarded as meeting this requirement.

3. The taxpayer participates for more than 100 hours during the year, and the taxpayer's participation is not less than any other individual's participation during the year.

4. The activity is a significant participation activity and the taxpayer's total participation in all significant participation activities exceeds 500 hours. A significant participation activity is one in which:

   a. The taxpayer cannot be treated as materially participating under any of the other six tests, and

   b. The taxpayer participates for more than 100 hours but fewer than 500 hours.

5. The taxpayer materially participated in the activity for any five of the 10 immediately preceding tax years.

6. The activity is a personal service activity, and the taxpayer materially participated in the activity for any three preceding years.

7. Facts and circumstances indicate that there was material participation on a regular, continuous, and substantial basis.

If the taxpayer meets the 750-hour test, they will also meet tests for material participation because they participated in the activity more than 500 hours during the year.

GROUPING ELECTION FOR RENTAL ACTIVITIES

BACKGROUND INFORMATION

The $25,000 Special Allowance for Rental Real Estate Activities

In general, passive activity losses may only be deducted to the extent of passive activity income. One of the most common exceptions to this rule is the **$25,000 special allowance** for rental real estate activities, which allows real estate rental losses to offset nonpassive income.[23]

> **Note.** The special allowance is available for most taxpayers who **actively participate** in rental real estate activities. Active participation is a less stringent standard than material participation. Active participation means making management decisions and/or arranging for others to provide services, such as repairs. Management activities include approving new tenants, deciding on rental terms, and approving capital or repair expenditures.

There are limitations and exclusions that preclude taxpayers from qualifying for the special allowance, even those who actively participate in the activities. One significant **limitation** is that the $25,000 special allowance begins to be phased out for most taxpayers whose adjusted gross income (AGI) exceeds $100,000. For MFS taxpayers who live apart from their spouse at all times during the tax year, the phaseout begins at $50,000 and the special allowance is limited to $12,500.

22. Temp. Treas. Reg. §1.469-5T(a).

23. IRC §469(i).

Exclusions. Rental real estate activities that do **not** qualify for the special allowance include the following.

1. The average period of customer use is seven days or less, such as vacation properties.
2. Significant personal services are provided and the average period of customer use is 30 days or less, such as hotels with maid service.
3. Extraordinary personal services are provided for the customer, such as hospitals.
4. The rental is incidental to a nonrental activity.
5. The taxpayer makes the property available for nonexclusive use by various customers of the property, such as golf courses.

Note. Self-rentals also do not qualify for the special allowance. Self-rentals are rentals to pass-through entities owned by the taxpayer, such as a commercial building rented to an S corporation. They are subject to special limitations not discussed here.[24] Also, they **cannot be grouped** with other rental activities.[25]

Material Participation and Grouping

The requirements to meet the material participation test are covered in the "Real Estate Professional" section of this chapter. Unless an election is made to the contrary, each rental real estate interest of the taxpayer must be treated as a separate activity. However, by grouping two or more rental activities into one, the taxpayer need only satisfy the material participation requirement for the grouped activity rather than for each separate rental activity.

When Grouping Is Appropriate

If a taxpayer does not qualify for the $25,000 special allowance because of one of the exceptions listed above, grouping the activities may allow the taxpayer to deduct the loss under the material participation provisions.

In addition, **if the taxpayer qualifies as a real estate professional,** grouping the activities may allow the taxpayer to deduct the losses under the material participation rules instead of being subject to the limitations applicable to the $25,000 special allowance.

When Grouping Is Not Appropriate

1. Once a rental property has been grouped with other properties, passive activity losses and credits cannot be used until the disposition of **substantially all** of the group.

   Explanation. Generally, passive activity losses (PAL) in excess of passive activity profits are suspended and carried forward to future years until they can be absorbed by excess passive profits. Credits attributable to passive activities are also suspended until they can be applied against regular income tax on passive activity profits.[26] However, suspended PAL/credits may be used against nonpassive income/tax when the taxpayer disposes of the entire passive activity to an unrelated party in a fully taxable transaction.[27]

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24. Treas. Reg. §1.469-2(f)(6).
25. *Carlos v. Comm'r,* 123 TC 16 (Sep. 20, 2004).
26. IRC §469.
27. IRC §469(g)(1)(A).

Example 7. Andy, an actor, owns three apartment buildings. His 2012 AGI is over $500,000. On his **2000 return, he elected** to treat the three rental real estate activities as a single passive activity. He does not qualify as a real estate professional.

His suspended passive loss carryover to 2012 is $90,000 for the rental activity. In 2012, he sells one of the apartment buildings to an unrelated person. He realizes a loss of $10,000 on the sale. He also incurs a $2,000 operating loss on the three apartment buildings for the year.

Question 7A. Does the sale of the apartment building in 2012 release the $90,000 of suspended losses?

Answer 7A. No. Andy made a prior election to treat the three apartment buildings as a single passive activity. The suspended losses will not be released until substantially all of the activity is completely disposed of to an unrelated party in a fully taxable transaction.

Question 7B. Will Andy be able to deduct the $10,000 loss in 2012 on the sale of the building?

Answer 7B. No. This loss is also suspended. The loss will be released when he has sufficient passive income to absorb it or he sells the remaining properties.

Question 7C. If Andy had not made the election to treat the three properties as a single activity, would the sale of one apartment building in 2012 trigger the release of the $90,000 of suspended losses?

Answer 7C. Not the whole $90,000. Andy is entitled to deduct the portion that relates to the building that is sold. He also can deduct the $10,000 loss on the sale and the portion of the 2012 operating loss attributable to that apartment building.

Question 7D. If Andy had sold the apartment building for a gain, would that change the tax result?

Answer 7D. Yes. The gain would qualify as income from a passive activity. The current-year operating loss and the suspended losses from prior years would be allowed up to the amount of the 2012 gain.

2. One activity may qualify under the material participation test without grouping, but may not qualify if grouped with other activities.

Example 8. Ben earns a substantial salary working 60 hours per week as an attorney for the town's leading legal firm. He dreams of a day when he will make a fortune with little effort. He has two rental properties that he hopes will become cash cows, but both are currently money pits. Neither of these properties qualifies for the $25,000 special allowance, because the average rental period is less than eight days.

He meets the test for material participation for Rental 1 because he works 110 hours per year managing it, and no one else spends any time on it. He does not meet the test for material participation for Rental 2 because he spends 50 hours per year managing it, and his friend, Grace, works 200 hours per year on it. If the activities are grouped, his 160 hours per year are less than Grace's 200 hours. Therefore, if grouped, both activities are passive, and the losses are suspended.

GROUPING THE ACTIVITIES

In order to group the activities, the taxpayer can use any reasonable method of applying relevant facts and circumstances in grouping activities to form an "appropriate economic unit." The following factors are considered in determining whether activities constitute an appropriate economic unit.

1. The similarities and differences in the types of trades or businesses
2. The extent of common control
3. The extent of common ownership
4. The geographical location
5. The interdependencies between or among activities, which may include the extent to which the activities:
    a. Buy or sell goods between or among themselves,
    b. Involve products or services that are generally provided together,
    c. Have the same customers,
    d. Have the same employees, or
    e. Use a single set of books and records to account for the activities.[28]

While rental activities generally cannot be grouped with trade or business activities, there is an exception when the activities form an appropriate economic unit and one of the following applies.[29]

1. The rental activity is insubstantial in relation to the trade or business activity.
2. The trade or business activity is insubstantial in relation to the rental activity.
3. Each owner of the trade or business activity has the same ownership interest in the rental activity, in which case the part of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

Example 9. Herbert and Wilma are married and file a joint return. Herbert is the only shareholder of Healthy Food, an S corporation, which is a retail grocery store business. The building is rented from Plum Tower, an S corporation, of which Wilma is the only shareholder. Plum Tower's grocery store rental business and Healthy Food's retail grocery business are not insubstantial in relation to each other.

Herbert and Wilma are treated as one taxpayer for purposes of the passive activity rules. Herbert and Wilma own both Healthy Food and Plum Tower with the same ownership interest (100% in each). If the grouping forms an appropriate economic unit, Herbert and Wilma can group Plum Tower's grocery store rental and Healthy Food's retail grocery business into a single trade or business activity.

MAKING THE ELECTION

The election to group activities is made by filing an attachment to the original return for the year for which the election is effective. A calendar-year taxpayer is not required to make an election for any grouping made **prior to January 1, 2010,** unless the taxpayer makes a change to the grouping. The election is effective for all subsequent years.

28. Treas. Reg. §1.469-4(c)(2).
29. Treas. Reg. §1.469-4(d)(1)(i).

New Elections

The election statement must identify the names, addresses, and employer identification numbers, if applicable, for activities that are being grouped as a single activity. In addition, any statement reporting a new grouping must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469.

Attachment to
Form 1040
Schedules E

NAME(S):	SSN/TIN:

ELECTION TO GROUP ACTIVITIES
PURSUANT TO INTERNAL REVENUE CODE REG. §1.469-4(c)
(Rental Real Estate)

The taxpayer hereby elects to group the following activities together so that the grouped activities are treated as a single activity for the tax year ended ______________, and all years thereafter. The taxpayer represents that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for the purposes of IRC §469.

Accordingly, the taxpayer hereby elects to group the following activities together so that the grouped activities are treated as a single activity under IRC §469(c)(7)(A) for the current tax year and all years thereafter. The following activities are to be grouped together and treated as one activity:

ACTIVITY	DESCRIPTION
	Name: ______________________________ Address: ______________________________ ______________________________ ______________________________ TIN (if applicable): ____________________
	Name: ______________________________ Address: ______________________________ ______________________________ ______________________________ TIN (if applicable): ____________________

NOTE: The above grouping election does not result in income or loss being grouped for self-employment tax purposes.

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Addition of New Activities to Existing Groupings

If a taxpayer adds a new activity to an existing grouping, the taxpayer must file a written statement with the original income tax return for that taxable year. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the new activity and the activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469.

Regroupings

If the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities. If such a regrouping is made, the taxpayer must file a written statement with the taxpayer's original income tax return for the taxable year in which the activities are regrouped. The statement must contain an explanation of why the taxpayer's original grouping was inappropriate or the nature of the change that makes the original grouping clearly inappropriate.

This statement must also identify the names, addresses, and employer identification numbers, if applicable, for all of the activities that are being regrouped. In addition, if two or more activities are regrouped into a single activity, the statement reporting a regrouping must contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469.

Automatic Late Election Relief for Real Estate Professionals

Effective June 13, 2011, Rev. Proc. 2011-34 provides a procedure granting automatic late election relief for the grouping election to taxpayers who qualify as real estate professionals. Generally, the taxpayer is required to attach the election to the first return for which the taxpayer wishes the grouping election to apply.[30]

The procedures outlined in Rev. Proc. 2011-34 should be utilized by eligible taxpayers to obtain relief for a late grouping election rather than requesting private letter rulings. User fees do not apply to corrective action under this procedure.

Note. A taxpayer who is not eligible for relief under this revenue procedure may request relief by applying for a private letter ruling. See Rev. Proc. 2011-1 for the requirements for requesting a private letter ruling.

Eligibility under Rev. Proc. 2011-34. A taxpayer is eligible for an extension of time to file a grouping election if the taxpayer meets all of the following requirements.

1. Failed to make a grouping election under Treas. Reg. §1.469-9(g) solely because the taxpayer failed to timely meet the requirements
2. Filed tax returns that are all consistent with the requested grouping as if an election under Treas. Reg. §1.469-9(g) had been made for all years including and following the year of the effective date of the grouping (The taxpayer must have filed all required federal income tax returns consistently with the requested grouping election. There can be no tax returns that contain positions inconsistent with the requested grouping during any of the taxable years.)
3. Timely filed each return that would have been affected by the election or within six months after its due date, excluding extensions
4. Had reasonable cause for the failure to meet the requirements in Treas. Reg. §1.469-9(g)

Procedure. To be eligible for the extension of time to file a grouping election, the taxpayer must attach the statement required by Treas. Reg. §1.469-9(g)(3) to an amended return for the most recent tax year. The amended return should be mailed to the IRS service center where the taxpayer will file their current year tax return.

30. Treas. Reg. §1.469-9(g)(3).

The statement must:

1. Contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to IRC §469(c)(7)(A),
2. Explain the reason for the failure to file a timely election,
3. Include a representation that the taxpayer meets the eligibility requirements (specified previously under "Eligibility under Rev. Proc. 2011-34"),
4. Identify the taxable year for which the taxpayer seeks to make the late election, and
5. State at the top of the document "**FILED PURSUANT TO REV. PROC. 2011-34**."

The statement must be accompanied by a dated declaration signed by individual(s) with personal knowledge of the facts and circumstances related to the election. The representation must state the following.

Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.

IRS Notification of Acceptance. The IRS provides written notification to the taxpayer when it receives a completed application that satisfies the requirements of the revenue procedure. The notification means that the taxpayer is treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity as of the taxable year for which the late election was requested.

FILING STATUSES: WHAT IS MOST BENEFICIAL?

Note. For more information on filing status rules and requirements see Chapter 3, Filing Status and Dependency Exemptions, in the 2011 *University of Illinois Federal Tax Fundamentals* workbook.

The taxpayer's filing status generally depends on the marital status of the taxpayer on December 31 of the tax year. More information about each specific status is provided below. Most taxpayers must file a 2012 return if their gross income meets the following threshold.

Filing Status	Age of Taxpayer on December 31, 2012	Gross Income at or Above
Single	Under 65	$ 9,750
	65 or older	11,200
Head of household (HoH)	Under 65	12,500
	65 or older	13,950
Married filing jointly (MFJ)	Under 65 (both spouses)	19,500
	65 or older (one spouse)	20,650
	65 or older (both spouses)	21,800
Married filing separately (MFS)	Any age	3,800
Qualifying widow(er) with dependent child	Under 65	15,700
	65 or older	16,850

Note. Whether social security benefits are included in gross income depends on total income and marital status. For more information, see 2012 Volume A, Chapter 1: Social Security and Retirement Planning.

SINGLE

The default filing status is single. It is used by any taxpayer who is unmarried or legally separated from their spouse and who does not qualify for any other filing status.

HEAD OF HOUSEHOLD

A taxpayer who qualifies to file as head of household (HoH) is unmarried, has paid more than half the cost of maintaining a home, and lives with a "qualifying person" for more than half the year. A qualifying person is one of the following.

1. **A qualifying child.** The child must be a relative and under age 19 or under age 24 if the child is a full-time student. The child does not have to be a dependent.
2. **A qualifying parent.** The relative is the taxpayer's parent. The parent must be the taxpayer's dependent, but the parent does not have to live with the taxpayer to qualify.
3. **A nonparental qualifying relative.** The person must be the taxpayer's dependent and must live with the taxpayer more than half of the year.

The taxpayer is **considered unmarried** (although still legally married) and eligible to file as HoH if the following requirements are met.

1. The taxpayer files a separate return from their spouse.
2. The taxpayer pays more than half the cost of maintaining a household.
3. The taxpayer's spouse did not live in the home for the last half of the year.
4. The taxpayer's home was the primary residence for the qualifying child for over six months of the tax year.

QUALIFYING WIDOW(ER)

The year the taxpayer's spouse dies, the taxpayer can file using the MFJ status. If there is a dependent child, the taxpayer may claim qualifying widow(er) (QW) status for two years after the death of the spouse and receive the same tax brackets and standard deductions as a taxpayer using the MFJ status.

MARRIED FILING JOINTLY

If a taxpayer is married on December 31, the taxpayer is considered married for the entire year. If the taxpayer is divorced by the last day of the year, the taxpayer is considered unmarried for the entire year. Taxpayers who are living apart but who are not legally separated under a decree of divorce or separate maintenance are considered married. Likewise, if they are separated under an interlocutory divorce decree but the divorce is not yet final, they are considered married for filing purposes.

Typically, married taxpayers file as MFJ. The taxpayers' income, adjustments, deductions, and exemptions are consolidated into one return. The tax brackets are double that of the single bracket until approximately $100,000 in taxable income. The standard deduction is double the single taxpayer's deduction.

Note. If the taxpayer receives a court decree of annulment, which holds that no valid marriage ever existed, then the taxpayer is considered unmarried even if the taxpayer filed joint returns for earlier years. The taxpayer must file amended returns on Form 1040X claiming single status or HoH status for all tax years affected by the annulment for which the statute of limitations has not expired. The statute of limitations is typically three years after the original return was filed.

MARRIED FILING SEPARATELY

Married taxpayers may choose to file separate returns. There are several **disadvantages** to filing separately. Some of these disadvantages include the following.[31]

1. The tax rate generally is higher than it would be on a joint return.
2. The exemption amount for calculating the alternative minimum tax is half that allowed to a joint return filer.
3. The taxpayer cannot take advantage of certain credits and deductions, such as the credit for child and dependent care expenses, earned income credit, credit for adoption expenses, education credits, or the deduction for student loan interest.
4. If the taxpayer lived with their spouse at any time during the tax year:
   a. They cannot claim the credit for the elderly or disabled, and
   b. They have to include in income 85% of any social security or equivalent railroad retirement benefit received.
5. The following credits are **reduced** at income levels that are half those for a joint return.
   a. Child tax credit
   b. Retirement savings contributions credit
6. The capital loss deduction limit is $1,500 (instead of $3,000 for taxpayers filing a joint return).
7. The taxpayer cannot claim the standard deduction if the other spouse itemizes.
8. The modified adjusted gross income threshold is only $10,000 for IRA contributions.

In general, the taxpayers pay more combined tax by filing separate returns than they would if the returns were filed jointly.

> **Note.** If the taxpayer and the spouse file separate returns, they can generally change their filing status to MFJ any time within three years from the due date of the separate return(s). To do this, the taxpayer simply files an amended return using Form 1040X. However, once a joint return is filed, the couple cannot choose to file separate returns for that year after the tax return due date passes.

There are circumstances, however, when the taxpayer may want to consider filing MFS. The taxpayer should consider MFS status when both spouses have taxable income and one spouse has significant itemized deductions that are limited by AGI. The three most common itemized deductions that are limited by AGI are the following.

1. Medical expenses, which are deductible only to the extent they exceed 7.5% of AGI
2. Personal casualty losses, which are deductible only to the extent they exceed 10% of AGI
3. Miscellaneous itemized expenses, including unreimbursed employee business expenses, fees for tax advice and preparation, and investment expenses, which are deductible only to the extent they exceed 2% of AGI

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31. IRS Pub. 501, *Exemptions, Standard Deduction, and Filing Information*.

In addition, a taxpayer may want to file MFS in the following situations.

- The spouse takes "aggressive deductions" or the taxpayer suspects the spouse of possible tax fraud. Filing separately prevents the taxpayer from becoming liable for taxes in arrears and penalties from having to qualify for innocent spouse relief.
- The spouse has unpaid child support obligations or has defaulted on student loans, in which case a joint return refund can be withheld to repay the spouse's liability.
- AGI levels also affect other nontax issues such as student loan repayment.

> **Note.** If the taxpayer lives in a community property state, the income and deductions may have to be split 50-50, which provides little advantage to filing MFS.

Example 10. Mary Sue and her husband Joe each earned $50,000 for the tax year. Mary Sue developed a severe case of whooping cough and racked up $7,000 in medical bills. The $7,000 falls short of the required 7.5% of combined AGI, so the medical expenses are not deductible on a joint return. However, if Mary Sue files a separate return, she can include $3,250 of her medical expenses ($7,000 – ($50,000 × 7.5%)) in her total itemized deductions.

> **Caution.** In this example, if Mary Sue itemizes, Joe must also itemize. See 2012 Volume C, Chapter 3: Schedule A, for information on this requirement.

MASTER LIMITED PARTNERSHIPS

A master limited partnership (MLP) is a publicly traded partnership that derives at least 90% of its income from qualifying sources. IRC §7704(b) states that a partnership is publicly traded if interests in the partnership are traded on an established securities market or interests are readily tradable on a secondary market. An MLP retains the favorable partnership tax treatment but is combined with the liquidity of a publicly traded security. The current form has been in place since the late 1980s. Publicly traded partnerships gained a large following in many types of businesses in the 1980s, which caused Congress to pass legislation in 1987 limiting the structure to specific types of qualifying income.[32]

Typically, most MLPs derive income from specific qualifying sources, including income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber).[33] Some real estate and financial firms may also qualify.

At the end of 2011, there were 76 energy-related MLPs. They had $300 billion in total market capitalization and $470 billion in enterprise value.[34] Growth in shale drilling and other continued oil and gas exploration efforts in the United States is making investments in MLPs more popular with investors.

An MLP consists of the limited partners, known as **unitholders,** and a general partner. Unitholders are entitled to cash distributions from the business, but they do not actively manage the business or control the assets of the partnership. General partners also own units in the partnership, which entitles them to distributions, and they receive compensation for the management of the partnership.

32. Bellamy, Ethan H. and Steffen, Timothy M., *Investing in MLPs: A Primer (*Robert W. Baird & Co. 2012).

33. IRC § 7704(d)(1)(E).

34. Bellamy, Ethan H. and Steffen, Timothy M., *Investing in MLPs: A Primer (*Robert W. Baird & Co. 2012).

General partners typically receive incentive distributions. These are typically based on quarterly distributions paid to the unitholders. Usually, under the incentive formula, the higher the quarterly distributions paid to the unitholders, the higher the management fee paid to the general partner, which can be an incentive for the general partner to pursue income-producing projects in an effort to boost distributions.[35]

MLPs avoid corporate income tax. All gains and losses are passed directly to the unitholders, eliminating the double taxation issue of corporate dividends. The partnership model also typically allows depreciation and depletion expenses to pass directly to unitholders as well, which provides tax deductions to unitholders to the extent of basis.

Note. When unitholders claim depreciation expenses, it reduces the cost basis of the units in the partnership. The depreciation expenses are subject to recapture upon sale of the unit. Like other equities, heirs receive a stepped-up basis in units acquired from the estate.

BENEFITS OF MLPs

Proponents of MLPs find benefits in investing in these entities because of the strict statutory provisions and the nature of the business. The vast majority of MLPs are pipeline businesses. These businesses earn a very stable income from the transport of oil, gasoline, or natural gas, and are not subject to the price fluctuations of the commodities themselves. MLPs own a significant share of the energy infrastructure in the United States, including pipelines, terminals, processing plants, and natural gas, gasoline, and oil storage facilities. This infrastructure is integral to much of the country's needs and provides a stable business that many tout as having consistently performed for investors. Yields have been stated to range from 4 to 9%.[36]

MAY BE UNSUITABLE FOR IRAs

MLPs provide tax benefits when held in taxable accounts. Depreciation and other expenses pass through to investors who may be able to reduce or eliminate their tax liability on the income received.[37]

The tax advantages are lost if the MLP is held in a tax-deferred account, such as an IRA. Ordinary income tax has to be paid on any distributions eventually taken. Further, if the investment generates unrelated business taxable income, the IRA is required to file a separate tax return and pay any tax due from the assets in the account.

Note. Suggested fixes for utilizing an IRA include converting the traditional IRA to a Roth IRA so there is no income tax incurred on future earnings. The issue of unrelated business income tax still exists under this scenario, however. Another solution is to make future investments in "closed-end" funds that invest in a number of publicly traded MLPs.[38]

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35. Gue, Elliott H. (2009, Oct. 10). Strong Parents Make Healthy MLPs. *Investing Daily.* [www.investingdaily.com/12833/strong-parents-make-healthy-mlps] Accessed on Jul. 3, 2012.

36. Bellamy, Ethan H. and Steffen, Timothy M., *Investing in MLPs: A Primer (*Robert W. Baird & Co. 2012).

37. Greene, Kelly (2009, Jul. 18). Master Limited Partnerships Have Benefits, Risks. *The Wall Street Journal.* [http://online.wsj.com/article/SB124786482493759951.html] Accessed on Jun. 28, 2012.

38. Ibid.

TAX IMPLICATIONS

Taxes on an MLP can be a bit challenging. The distributions are taxed at the marginal rate of the individual unitholder, but most of the distributions create tax-deferred income.

> **Note.** MLPs are most effective as long-term investments because of capital gains taxes and depreciation recapture upon the sale of the unit. This may eliminate the tax incentives realized during the investment period.

Schedule K-1

Investors who own MLP equities receive a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* for each taxable year. The Schedule K-1 reports the partner's share of the total income earned by the MLP. This is reported on the unitholder's tax return.

> **Caution.** Investors should be prepared for the possibility that they may have to file and pay state taxes outside their state of residence, depending on where the MLP earned income.

> **Note.** Suggested methods to avoiding dealing with a Schedule K-1 include purchasing MLP closed-end funds, exchange-traded notes, or utilizing other wrap products that provide a Form 1099 rather than a K-1.[39]

Passive Loss

MLPs are subject to passive loss issues. In most instances, operating losses can only be deducted for a business in which the taxpayer is actively engaged. Unitholders are limited partners and are not involved in the day-to-day business of managing the partnership. Therefore, these losses are passive losses and can only be used to offset passive gains. **With MLPs, however, the passive gains can only come from the same partnership, or applied when the unitholder sells their interest.[40]**

Example 11. George purchases an MLP unit for $100. He receives an annual distribution in the amount of $10. George reports only $1 of the distribution as ordinary income. The remaining $9 is considered a return of capital. George's basis in the unit is reduced to $91 after the first year because of the return of capital.

After 10 years of receiving the same $10 distribution, George sells the unit for $140. At the time of the sale, his basis in the unit has been reduced to $10 ($100 purchase price – ($9 return of capital × 10 years)). George has to pay taxes on $90 from the sale as ordinary income due to the depreciation recapture. The remaining $40 is treated as a long-term capital gain.

Quarterly Dividends/Return of Capital

Typically, distributions are made quarterly. These distributions are referred to by other names, but they are considered a return of capital by the IRS. This is the net income generated by the MLP that is allocated proportionately to the individual unitholders.

Because of depreciation allowances of 80 to 90%, a distribution received by the unitholder is mostly tax-deferred. The remaining portion of the distribution is taxed at the full income tax rate of the unitholder.

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39. Bellamy, Ethan H. and Steffen, Timothy M., *Investing in MLPs: A Primer* (Robert W. Baird & Co. 2012).

40. Ibid.

Tax Offsets

MLPs pass through deductions and tax credits, including depreciation. It is the high depreciation allowances that create the tax-deferred return of capital. However, depreciation is subject to recapture at ordinary income rates when the unit is sold.[41]

Basis and Capital Gains on Sale

MLPs are treated similarly to other partnerships. The tax basis is established when the investor buys into the partnership. The basis is increased by the unitholder's share of the profits, partnership debts, and any additional money invested in the partnership. The basis is decreased by the unitholder's share of the losses, any reduction in debt, or any money distributed. When the taxpayer sells a unit, they need to know the cost basis of the unit. The taxes paid depend on previous depreciation deductions and gains from the sale.

When the basis reaches zero, the distributions are fully taxable. In order to get the full benefit of the investment, the best option is to leave the units in the estate to enable the heirs to acquire the units at a stepped-up basis. The stepped-up basis is then used for depreciation, which allows the heirs to utilize the tax-deferred properties of the investment for years.

OFFSHORE VOLUNTARY DISCLOSURE PROGRAM EXTENDED

OBJECTIVE

The offshore voluntary disclosure initiative (OVDI), utilized in 2009 and 2011, has been reopened for 2012. The program will remain open for an unspecified period of time. The program coincides with continued efforts by the IRS and the Justice Department to pursue criminal prosecution of international tax evasion.[42]

The 2012 program is similar to the 2011 program in many ways, but there are a few key differences. The biggest difference is that there is no set deadline by which the taxpayer must apply. The overall penalty structure for the new program is the same as it was for 2011, except for taxpayers in the highest penalty category who are assessed higher penalty costs under the 2012 program.

The OVDI may be beneficial for taxpayers who have failed to meet the reporting requirements for foreign income and accounts. The program assesses costs to the taxpayer for the failure to comply, but the program costs may be significantly less than the civil and criminal penalties that can be assessed if no disclosure is made.

> **Note.** In the case of co-owners, each taxpayer must make a voluntary disclosure and pay the OVDI penalty on the taxpayer's highest aggregate balance in the account. The co-owners' disclosure is effective only for their own liability. The IRS may examine any other co-owner who does not make a disclosure.

The remainder of this section explains some of the required foreign account disclosures and potential civil and criminal penalties that can be imposed for failure to properly report these accounts and transactions.

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41. Baldwin, William (2010, Dec. 2). Tax Guide to Master Limited Partnerships, *Forbes*. [www.forbes.com/sites/baldwin/2010/12/02/tax-guide-to-master-limited-partnerships/] Accessed on Jun. 28, 2012.

42. IRS News. Rel. IR-2012-5 (Jan. 9, 2012).

REPORTING REQUIREMENTS FOR FOREIGN ACCOUNTS

Practitioners are cautioned to make a thorough inquiry of taxpayers about foreign accounts before checking the boxes in Part III of Form 1040, Schedule B, *Interest and Dividends.*

Note: If line 6 is over $1,500, you must complete Part III.

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.	**Yes**	**No**
	7a At any time during 2012, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
	If "Yes," are you required to file Form TD F 90-22.1 to report that financial interest or signature authority? See Form TD F 90-22.1 and its instructions for filing requirements and exceptions to those requirements		
	b If you are required to file Form TD F 90-22.1, enter the name of the foreign country where the financial account is located ▶		
	8 During 2012, 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		

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There are several significant reporting requirements for foreign income and accounts. These include the following.

- **Form TD F 90-22.1,** *Report of Foreign Bank and Financial Accounts* (FBAR), must be filed annually, disclosing all foreign financial accounts for which the taxpayer has a direct or indirect financial interest, signature authority, or other authority if the aggregate value of the account exceeded $10,000 at any time during the year. This is a **separate** filing and not an attachment to the taxpayer's 1040. The filing deadline is June 30 for foreign financial interests as of December 31 of the previous year. There is no extension to file available.

- **Form 8938,** *Statement of Specified Foreign Financial Assets,* is used to report the ownership of specified foreign financial assets if the total value of those assets exceeds an applicable threshold amount (the "reporting threshold"). The reporting threshold varies depending on whether an individual lives in the United States or files a joint income tax return. This form is filed with the taxpayer's Form 1040 if applicable.[43]

- **Form 3520,** *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,* and **Form 3520**-A, *Annual Information Return of Foreign Trust With a U.S. Owner,* are used to report transactions involving foreign trusts.[44]

- **Form 5471,** *Information Return of U.S. Persons With Respect To Certain Foreign Corporations,* must be filed by officers, directors, or shareholders in certain foreign corporations.[45]

- **Form 5472,** *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business,* is used to report transactions that occur during the tax year of a reporting corporation with a foreign or domestic related party.[46]

- **Form 926,** *Return by a U.S. Transferor of Property to a Foreign Corporation,* is used to report transfers of tangible or intangible property to foreign corporations.[47]

- **Form 8865**, *Return of U.S. Persons With Respect to Certain Foreign Partnerships,* is used to report interests in and transactions with foreign partnerships.[48]

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43. See the instructions for Form 8938.
44. IRC §6048(b).
45. IRC §§6038 and 6046.
46. IRC §§6038A and 6038C.
47. IRC §6038B.
48. IRC §§6038, 6038B, and 6046A.

POTENTIAL PENALTIES FOR NONDISCLOSURE

Civil Penalties

Depending on a taxpayer's particular facts and circumstances, the following significant penalties may apply to taxpayers who do not participate in the OVDI and have omissions or errors that are discovered by the IRS.

- A person who willfully fails to file an FBAR (TD F 90-22.1) is assessed the greater of $100,000 or 50% of the total balance of the foreign account per violation.[49] Violations that are not willful are subject to a $10,000 penalty per violation.
- A person who fails to file a complete and correct Form 8938 is subject to a penalty of $10,000. If they receive a notice from the IRS that a Form 8938 is due but has not been filed, then they must file a Form 8938 within 90 days and are subject to an additional penalty of $10,000 for each 30-day period (or part of a period) in which the form has not been filed. The taxpayer may also be subject to criminal penalties.
- A person who fails to file a complete and correct Form 3520 is generally subject to a penalty that is the greater of $10,000 or 35% of the gross reportable amount, except for returns reporting gifts. For gifts, the penalty is 5% of the amount of the gift per month, up to a maximum penalty of 25%.
- A person who fails to timely file a complete and correct Form 3520-A is subject to a penalty that is the greater of $10,000 or 5% of the gross value of trust assets determined to be owned by the U.S. person.
- A person who fails to file a complete Form 5471 is subject to a $10,000 penalty. An additional $10,000 penalty applies for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.
- A person who fails to file a Form 5472 or to keep certain records regarding reportable transactions is subject to a $10,000 penalty, with an additional $10,000 added for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency.
- A person who fails to file a Form 926 is assessed a penalty of 10% of the transferred property's FMV. The penalty is limited to a maximum of $100,000 per return unless the failure to comply was due to intentional disregard.
- A person who fails to file a Form 8865 is subject to a $10,000 penalty. An additional $10,000 penalty is added for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return. A person who fails to properly report a contribution to a foreign partnership is subject to a penalty of 10% of the FMV of any transferred property that is not reported. This penalty is subject to a $100,000 limit, unless the failure is due to intentional disregard.
- Fraud penalties of 75% of the unpaid tax may be imposed under IRC §§6651(f) or 6663.
- The penalty for failure to file a tax return imposed under §6651(a)(1) is 5% of the balance due, plus an additional 5% for each month or fraction of a month during which the failure continues, up to a maximum of 25%.
- The penalty for failing to pay the amount of tax shown on the return under §6651(a)(2) is 0.5% of the amount of tax due but unpaid. An additional 0.5% penalty may be assessed for each additional month or fraction of a month that the amount remains unpaid, up to a maximum of 25%.
- An accuracy-related penalty of 20 to 40% may be imposed on underpayments under IRC §6662.

> **Note.** Circular 230 requires a tax return preparer who knows about a client's noncompliance to advise the client of the consequences of the noncompliance. If the client declines to make a full disclosure, the preparer cannot prepare the client's income tax return for that year without violating Circular 230 provisions.

49. See the instructions for Form TD F 90-22.1.

Criminal Penalties

Possible criminal charges related to tax returns include tax evasion subject to up to five years in prison and a fine up to $250,000.[50] Filing a false return can result in a 3-year prison term and $250,000 fine.[51] Failure to file an income tax return may result in a 1-year prison sentence and a fine of $100,000.[52] Willfully failing to file an FBAR and willfully filing a false FBAR are also criminal violations subject to prison terms of up to 10 years and fines of up to $500,000.[53]

ELIGIBILITY RULES

Applications for the OVDI that are filed after 2011 are considered under the provisions of the new OVDI program.[54]

Taxpayers are not eligible to participate in the OVDI if the IRS has already initiated a civil examination, regardless of whether it relates to undisclosed foreign accounts. Taxpayers under criminal investigation are also ineligible.

Taxpayers are eligible to participate in the OVDI if they have made "quiet" returns by filing amended returns and paying related tax and interest without directly notifying the IRS of their failure to disclose foreign income and accounts. However, once an audit of a quiet return commences, the taxpayer is ineligible to participate in the OVDI.

Participants in the 2009 OVDI are not eligible to participate in the new program.

INCENTIVES FOR PARTICIPATION

Taxpayers with undisclosed foreign accounts or entities who choose to make a voluntary disclosure can avoid substantial civil and criminal penalties. Following the process for a voluntary disclosure also provides certainty and finality in calculating the cost of resolving all offshore tax issues.

> **Note.** The IRS may have better access to information regarding U.S. taxpayers' foreign accounts and transactions as more information becomes available through the requirements of the Foreign Account Tax Compliance Act (FATCA) and foreign financial asset reporting laws (IRC §6038D).

ASSESSED COSTS UNDER OVDI

Individuals are required to pay a penalty of 27.5% of the highest aggregate balance in foreign bank accounts or the value of foreign assets during the eight full tax years prior to the disclosure. This is an increase from the 25% assessed under the 2011 program.

Participants must file all original and amended tax returns and include payment for back taxes and interest for up to eight years as well as paying accuracy-related and/or delinquency penalties. This is an increase over the typical 3-year period.

Taxpayers in certain situations can qualify for a reduced 5% penalty. Smaller offshore accounts are subject to a 12.5% penalty. Offshore accounts or assets not greater than $75,000 in any calendar year may qualify for the lower rate. Taxpayers may opt out of the program and choose to be examined instead if the penalties under the program seem disproportionate.

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50. IRC §7201.
51. IRC §7206(1).
52. IRC §7203.
53. See IRC §5322.
54. IRS News Rel. IR-2012-5 (Jan. 9, 2012).

Taxpayers who reported and paid tax on all taxable income but did not file FBARs should not use the OVDI procedure. These taxpayers should file the delinquent reports with an explanation for the late filing. The reports should be sent to the following address.

Department of Treasury
PO Box 32621
Detroit, MI 48232-0621

There is no penalty for failure to file the report as long as there are no underreported tax liabilities and the reports are filed during the time the OVDI is still accepting applications.

REQUIREMENTS FOR APPLICATION

Under the terms of the OVDI, the taxpayer is required to do the following.

- Provide copies of previously filed tax returns, including any amended returns covered by the voluntary disclosure.
- Provide amended federal income tax returns for all tax years covered by the disclosure, including applicable schedules detailing the amount of previously unreported income from the account or entity.
- Provide copies of the completed and signed OVDI letter.
- File complete and accurate original or amended information returns and FBARs for the calendar years 2004–2011.
- Cooperate in the process and provide information on offshore financial accounts, institutions, and facilitators.
- Sign all agreements extending the statutory period for assessing taxes and penalties.
- Provide disclosures regarding offshore financial accounts and offshore entities.
- Pay penalties, including the following.
  - 20% accuracy-related penalties on the full amount of tax underpayments for all years
  - Failure-to-file penalties under IRC §§6651(a)(1) and 6651(a)(2), if applicable
- Pay 27.5% of the highest aggregate balance in foreign bank accounts or the value of foreign assets during the period covered by the disclosure. This penalty may be reduced to 12.5% or 5% in certain situations.[55]
- Attach a statement that indicates whether the returns involve passive foreign investment company (PFIC) issues, and if so, whether the applicant chooses to elect the alternative to the statutory PFIC computation. PFIC returns have the option of utilizing mark-to-market methodology authorized in IRC §1296. A complete reconstruction of historical data is not required.[56]
- Submit full payment of all tax, interest, accuracy-related penalties, and failure-to-file penalties or make good-faith arrangements with the IRS to pay in full.
- Execute a Form 906, *Closing Agreement on Final Determination Covering Specific Matters.*

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55. For more information, see *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers.* Aug. 4, 2012. [www.irs.gov/Businesses/International-Businesses/2011-Offshore-Voluntary-Disclosure-Initiative-Frequently-Asked-Questions-and-Answers] Accessed on Sep. 6, 2012.

56. Ibid.

Example 12. Michele has a foreign account with $1 million in 2004. The account earns interest of $50,000 per year (for simplicity, this scenario does not account for compounding interest). Michele's account balance in 2004 is $1.05 million. In 2011, the balance has increased to $1.4 million. Michele chooses to participate in the OVDI. She is liable for $553,000, which is computed as follows.

1. Tax of $140,000 ($50,000 interest × 35% tax rate × 8 years) plus interest
2. An accuracy-related penalty of $28,000 ($140,000 × 20%)
3. OVDI penalty in lieu of other penalties that may apply, which is $385,000 ($1.4 million × 27.5%)

If the IRS discovered Michele's offshore activities and assessed civil penalties, the amount owed would be more than $4.5 million in addition to potential criminal penalties.[57]

OVERVIEW OF OVDI PROCESS

1. **Preclearance process.** This step is not required. Taxpayers or their representatives can fax the following information to the IRS Criminal Investigation Lead Development Center at 267-941-1115.

   a. The taxpayer's name

   b. Date of birth

   c. Social security number

   d. Taxpayer's address

   e. Executed power of attorney for the representative

   The criminal investigation unit notifies taxpayers via fax whether they are cleared for voluntary disclosure. Preclearance does not guarantee acceptance into the OVDI.

2. **Offshore voluntary disclosure letter**

   a. If the taxpayer received a preclearance notice, the taxpayer has 30 days from the receipt of the notice to complete the offshore voluntary disclosure letter.

   b. If the taxpayer bypassed the preclearance process, the taxpayer must mail the offshore voluntary disclosure letter to the IRS at the following address.

      Internal Revenue Service
      Criminal Investigation
      ATTN: Offshore Voluntary Disclosure Coordinator
      Philadelphia Lead Development Center
      1-D04-100
      2970 Market Street
      Philadelphia, PA 19104

   c. Upon review of the offshore voluntary disclosure letter, the IRS notifies the taxpayer whether the disclosure has been preliminarily accepted.

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57. This example is based on the illustration provided in *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers.* Aug. 4, 2012. [www.irs.gov/Businesses/International-Businesses/2011-Offshore-Voluntary-Disclosure-Initiative-Frequently-Asked-Questions-and-Answers] Accessed on Sep. 6, 2012.

3. **Complete voluntary disclosure package.** As soon as the taxpayer has received preliminary acceptance into the OVDI program, the taxpayer should send the full disclosure package to the following address.

   Internal Revenue Service
   3651 S. I. H 35 Stop 4301 AUSC
   Austin, TX 78741
   ATTN: Offshore Voluntary Disclosure Initiative

4. **Opt-out procedure.** A taxpayer may choose to opt out of the civil settlement structure. This option is irrevocable. In certain scenarios, it may be financially advantageous for the taxpayer to choose to opt out of the program depending on the type of account and amounts involved. Specific scenarios can be found in *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers,* which can be accessed along with additional documents at **www.irs.gov/Businesses/International-Businesses/2011-Offshore-Voluntary-Disclosure-Initiative-Frequently-Asked-Questions-and-Answers.**

Note. The IRS does not provide a timeline for completion of the process, but suggests that the taxpayer expedite the process by having delinquent and amended returns completed early because they must be submitted with the final disclosure package. The taxpayer should also gather all the necessary statements and documents needed to certify the disclosure as soon as possible.