2014 INDIVIDUAL & EMPLOYEE
FEDERAL TAX UPDATE

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FEDERAL TAX UPDATE

WHAT'S NEW

TAX REFORM

What's All The Fuss About?

Tax reform has become a part of every politician's stump speech lately. Dave Camp, House Ways and Means Committee Chair, and Max Baucus, former Senate Finance Committee Chair, toured the United States in the summer of 2013 to drum up support for tax reform. Arguing that the current tax system is overly complicated and burdensome, these two politicians promised to listen to America and then devise a simpler and fairer tax system. What came out during this tour (1) is that most Americans believe the current tax system should be reformed, but they also don't want deductions or credits they personally are able to take advantage of taken away and (2) a 979-page tax reform proposal from Congressman Camp. Given all the discussion, a general overview of our current tax systems seems appropriate.

Tax Deductions and Credits as Federal Tax Expenditures

Tax expenditures represent revenue losses from tax deductions, credits, and other tax benefits. For example, the mortgage interest deduction reduces the total amount of Federal tax revenue collected in a given year and is thus considered a tax expenditure. The Joint Committee on Taxation listed the revenue losses from these tax provisions by functional spending categories. While it is not precisely correct to add up all tax expenditures, which are estimated individually yet have some interactive effects, these totals provide some notion of the magnitude of these provisions. Individual income tax receipts are projected to be $1.264 trillion in 2013.

Largest Tax Expenditures for Individuals, FY 2013 (CRS Report Table 6)	
Tax Expenditure	**Amount (in Billions)**
Capital gain and dividend rate reduction	$160.8

Largest Tax Expenditures for Individuals, FY 2013 (CRS Report Table 6)	
Tax Expenditure	**Amount (in Billions)**
Employer provided health benefits exclusion	$131.7
Retirement plan contributions and earnings exclusion, including IRAs	$117.2
Mortgage interest deduction	$ 69.7
Medicare benefit exclusion	$ 67.0
Earned income tax credit	$ 60.9
Child tax credit	$ 57.3
State and local tax deduction	$ 50.3
Exclusion of capital gains at death	$ 42.8
Charitable contribution deduction	$ 39.0
Source: CRS analysis of data from U.S. Congress, Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2012 - 2017, 112th Congress, Feb. 1, 2013, JCS-1-13	

Origins of Federal tax revenues vary over the years. In 2012 the sources of Federal revenues were: individual income taxes - 46%; Social Security and Medicare programs - 35%; corporate income taxes - 10%; estate, gift, customs duties, and other taxes - 6%; and excise taxes - 3%.

Historical Look at Taxes as a Percentage of Federal Revenue (CRS Report - Figure 2)				
	1952	**1972**	**1992**	**2012**
Personal income tax	42%	44%	43%	46%
Social Security and payroll tax	10%	28%	34%	35%
Corporate income tax	32%	14%	11%	10%
Estates, other taxes	3%	6%	6%	6%
Excise taxes	13%	8%	6%	3%
Total	100%	100%	100%	100%
Source: CRS calculations using data from U.S. Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2014, Historical Tables (Washington: GPO, 2013).				

AMERICAN TAXPAYER RELIEF ACT OF 2012

3 for 1 Tax Bill

After months of wrangling, Congress finally passed legislation in the early morning hours of January 1, 2013. Essentially the legislation gave us three tax bills in one: (1) most provisions that expired at the end of 2011 were extended; (2) most provisions of the 2001 and 2003 tax bills were made permanent; and (3) AMT has been permanently patched. The legislation at least temporarily averted the "fiscal cliff" and gave tax professionals and taxpayers alike some certainty to make future plans. However, there are still many provisions of the tax code that expire again at the end of 2013. Congress and the White House have implied that tax reform of some fashion may happen in the not too distant future. Our advice - don't hold your breath!

Permanent Extension for Most Provisions of the 2001 and 2003 Bush Era Tax Cuts

Provision	**New Expiration Date**
10%, 15%, 25%, 28%, 33%, and 35% tax rates retained. 39.6% rate added.	Permanent
Marriage penalty relief for nonitemizers and for those in the 10% or 15% tax brackets	Permanent
0% and 15% capital gain rates retained. 20% capital gain rate added.	Permanent
Qualified dividends taxed at capital gain rates	Permanent
$1,000 child tax credit (formerly $500)	Permanent
Enhanced dependent care credit	Permanent
Enhanced adoption credit	Permanent
AMT exemptions amounts and nonrefundable credit provisions	Permanent
Coverdell education savings accounts	Permanent
Employer education assistance	Permanent
Enhanced student loan deduction	Permanent
Personal exemption phaseout (PEP) based on AGI added	Permanent
Itemized deduction phaseout based on AGI added	Permanent
$5,000,000 inflation adjusted estate exclusion ($5,340,000 for 2014)	Permanent
Portability of deceased spouse unused exemption amount	Permanent

2013 Expiration Date for Many Tax Provisions

Individual Provisions	**New Expiration Date**

Individual Provisions	**New Expiration Date**
Election for itemizers to deduct sales tax in lieu of income tax	December 31, 2013
Mortgage insurance premium deduction as mortgage interest	December 31, 2013
Tuition deduction	December 31, 2013
$250 teacher supply deduction	December 31, 2013
IRA transfers to charity in lieu of RMDs	December 31, 2013
Exclusion for personal residence COD income	December 31, 2013
Contributions of real property for qualified conservation purposes	December 31, 2013
Residential energy credit	December 31, 2013
Business Provisions	**New Expiration Date**
$500,000 §179 expensing limit	December 31, 2013
50% bonus depreciation for qualified purchases	December 31, 2013
15 year recovery period for qualified leasehold improvements, qualified restaurant property, and qualified retail improvements	December 31, 2013
Increased fringe benefit allowance for transit passes	December 31, 2013
Enhanced charitable deductions for food inventory	December 31, 2013
Basis adjustment to S corp stock for charitable contributions	December 31, 2013
Reduced built-in gains recognition period for S corporations	December 31, 2013
100% gain exclusion for qualified §1202 stock	December 31, 2013
WOTC for employers hiring qualified veterans and employees from other targeted groups	December 31, 2013
Wage credit for activated military reservists	December 31, 2013
R & D tax credit	December 31, 2013
Individual Provisions	**New Expiration Date**
Reduced earnings threshold for refundable child tax credit	December 31, 2017
Increased EIC for larger families, EIC simplification provisions	December 31, 2017
American Opportunity Tax Credit	December 31, 2017

Extender legislation. The Senate Finance Committee has sent to the Senate legislation that extends for two years 55 expiring provisions at a cost of $86 billion over 10 years. With our dysfunctional Congress, legislation may still be a long way off.

Top Tax Rate Increased to 39.6% (Rev. Proc. 2013-15, Sec. 2.01)

The American Taxpayer Relief Act of 2012 included several tax increases, most notably, an increase to the top marginal tax rate from 35% to 39.6% which began in 2013. The new higher rate applies to taxable income in excess of $400,000 for single taxpayers ($450,000 for married taxpayers filing jointly). The thresholds are annually adjusted for inflation.

2014	Single	HOH	MFJ
33%	$186,350 - 405,100	$206,600 - 405,100	$226,850 - 405,100
35%	$405,100 - 406,750	$405,100 - 432,200	$405,100 - 457,600
39.6%	Over $406,750	Over $432,200	Over $457,600

Preparer note. The 35% bracket is extremely narrow and is almost nonexistent for single taxpayers.

Can you say marriage penalty? The new tax brackets and other tax increases obviously create a greater marriage penalty. The Tax Policy Center has created an online marriage penalty tax calculator which is available at http://taxpolicycenter.org/taxfacts/marriagepenaltycalculator.cfm.

Phase outs of personal exemptions and itemized deductions. The Bush era Personal Exemption Phaseout (PEP) provision has been reinstated, which reduces the value of each personal exemption by 2% for each $2,500 above specified income thresholds. In addition, the re-instituted phaseout limitation on itemized deductions is reduced by 3% of adjusted gross income (AGI) above specified thresholds (but this reduction cannot be more than 80% of the affected itemized deductions).

AFFORDABLE CARE ACT (ACA)

Health Care Reform Impacts Most Businesses and Individuals

The Affordable Care Act (P.L. 111-148), signed by the President on March 23, 2010, as amended by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) and signed by the President on March 30, 2010, implements fundamental health care reforms and requires many of the 32 million uninsured individuals to obtain health care coverage or pay penalties. Most lower-income individuals, along with some middle-class families, will receive government help to pay for health insurance purchased at state Exchanges. ACA contains more than $400 billion in new taxes and revenue raisers on employers and individuals. Major changes you and your clients can expect include:

1. Individuals without health insurance will owe a penalty (tax) starting in 2014;
2. Employers with 100 or more full-time employees must offer affordable health insurance to their

employees beginning in 2015 or pay a penalty (employers with 50 to 99 employees have until 2016 to provide health insurance to their employees);

3. State insurance marketplaces have been established to allow clients to shop for insurance;
4. Employee Medicare tax increased by 0.9% (total of 2.35%) on annual wages for married couples with an AGI over $250,000 and singles with an AGI over $200,000 starting in 2013;
5. A new Medicare tax of 3.8% applies on net investment income for married couples with AGI over $250,000 and singles with AGI over $200,000 starting in 2013;
6. Extensive new penalties apply on tax shelters;
7. The "haircut" to deduct medical expenses increased from 7.5% to 10% of AGI starting in 2013; and
8. FSA contributions for medical expenses are limited to $2,500 starting in 2013.

Tax Time Line in the Affordable Care Act		
IRC Section	**Provisions**	**Effective Date**
2013		
56(b)(1)(B) (tax year); 213	Medical expense deduction increases to 10% after 2012, after 2017 for people 65 or older	after 12-31-12
125(i)(1)	FSA contributions limited to $2,500	after 12-31-12
164(f); 1401(b)	0.9% Medicare tax increase on SE income and employee wages when AGI exceeds $200,000 ($250,000 combined wages MFJ)	after 12-31-12
1411	New 3.8% Medicare tax assessed on net investment income of individuals, estate, and trusts with AGI over $200,000 single and $250,000 MFJ	after 12-31-12
2014		
5000A(a)	"Shared responsibility penalty" assessed against taxpayers who do not have health coverage. Penalty is phased in over three years starting in 2014 at $95 per individual ($285 per family), in 2015 at $325 per individual ($975 per family), and in 2115 $695 per individual ($2,085 per family).	after 12-31-13
36B	Individuals between 100% and 400% of federal poverty level will qualify for refundable tax credit ("premium assistance credit") to offset exchange-purchased health insurance premiums	after 12-31-13
2015		
4980H	Employers with at least 100 full-time employees may be subject to penalty if not offering health insurance coverage	after 12-31-14

Tax Time Line in the Affordable Care Act		
IRC Section	**Provisions**	**Effective Date**
	to full-time employees	
6056	Reporting of large employer health insurance coverage	after 12-31-14
2016		
4980H	Employers with at least 50 but fewer than 100 full-time employees may be subject to penalty if not offering health insurance coverage to full-time employees	after 12-31-15
2018		
4908I(b)(3)(C)	40% excise tax assessed against "Cadillac" employer sponsored health plans where the premium exceeds \$10,200 for individual coverage and \$27,500 for family coverage.	after 12-31-17

FILING STATUS

All Legal Same-Sex Marriages will be Recognized for Federal Tax Purposes (Windsor V. United States; Rev. Rul. 2013-17; Treasury Department News Release JL-2153; IR 2013-72; Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law; CRS Report for Congress—The Potential Federal Tax Implications of United States v. Windsor)

On June 26, 2013, the U.S. Supreme Court, in ***Windsor v. United States,*** ruled Section 3 of the 1996 Defense of Marriage Act (DOMA) unconstitutional. In rendering its decision, the Court changed the way same-sex married couples are treated under federal tax law.

What now for same-sex married couples? There are more than 1,100 places in federal law and 198 separate Internal Revenue Code provisions tied to marital status (highlighting the dramatic impact of marriage on personal taxes).

IRS issues Revenue Ruling on same-sex marriage. Effective September 16, 2013, Rev. Rul. 2013-17 implements Federal tax aspects of the June 26th Supreme Court decision invalidating a key provision of the 1996 Defense of Marriage Act. Under the ruling same sex couples will be treated as married for all Federal tax purposes, including income and gift and estate taxes. The ruling applies to all Federal tax provisions where marriage is a factor, including filing status, claiming personal and dependency exemptions, taking the standard deduction, employee benefits, contributing to an IRA, and claiming the earned income tax credit or child tax credit. Any same-sex marriage legally entered into in one of the 50 states, the District of Columbia, a U.S. territory, or a foreign country will be covered by the ruling.

> **Preparer note.** See IRS's FAQs when filing tax returns for same sex couples, updated Mar. 7, 2014.

All legal same-sex marriages will be recognized for federal tax purposes. The IRS ruled that same-sex couples, legally married in jurisdictions that recognize their marriages, will be treated as married for federal tax purposes. The ruling applies regardless of whether the couple lives in a state that recognizes same-sex marriage or a state that does not recognize same-sex marriage.

> **State issues for same-sex couples.** For legally married couples living outside of a marriage recognition state, generally, the couple will use a married filing status for federal purposes but their state may require that they continue to file as "single" or "head of household."

Joint or married separate filing required for years beginning in 2013. Legally-married same-sex couples generally must file their 2013 federal income tax return using either the "married filing jointly" or "married filing separately" filing status.

Prior years. Under the terms of Rev. Rul. 2013-17 individuals who were in same-sex marriages ***may***, but are not required to, file amended returns choosing to be treated as married for federal tax purposes for one or more prior tax years still open under the statute of limitations.

IRS Explains Treatment of Marriages of Same-Sex Couples for Retirement Plan Purposes after the Windsor Decision (Notice 2014-19)

Notice 2014-19 gives additional guidance on how qualified retirement plans should treat the marriages of same-sex couples. Notice 2014-19:

- gives examples of IRC requirements under which the marital status of the participants is relevant to the payment of benefits,
- provides guidance on how to satisfy those requirements in light of Windsor and Revenue Ruling 2013-17, and
- describes when retirement plans must be amended to comply with Windsor, Revenue Ruling 2013-17, and Notice 2014-19.

Plan amendments required with respect to plan provisions inconsistent with Windsor. If its terms are inconsistent with Windsor or Revenue Ruling 2013-17, a retirement plan must be amended to comply with Windsor and Revenue Ruling 2013-17. For example, a plan must be amended if it defines "spouse" by reference to section 3 of DOMA, or only as a person of the opposite sex. Required amendments must be adopted by the later of December 31, 2014, or the applicable date under the IRS' general amendment guidance for qualified retirement plans, Revenue Procedure 2007-44.

FAQs for more information. See the FAQs on the treatment of same-sex marriages for additional guidance, including:

- beneficiary designations in profit-sharing plans after Windsor,
- amendments that reflect the outcome of Windsor for periods before the decision was issued, and
- application of the outcome of Windsor to 403(b) plans.

Civil Unions and Registered Domestic Partners (RDPs) (Rev. Rul. 2013-17; Answers to FAQs for Registered Domestic Partners and Individuals in Civil Unions; Form 8959; Pub 555(

A registered domestic partner (RDP) is one-half of a couple, typically same-sex, who files a notice of their committed long-term relationship with a jurisdiction that recognizes such unions. The IRS has issued new rules, and posted FAQs, regarding the division of income, deduction, and withholding for California's RDPs on their Federal income tax return.

For Federal tax purposes, the term "marriage" does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a marriage under that state's law, and the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals who have entered into such a formal relationship. This conclusion applies regardless of whether individuals who have entered into such relationships are of the opposite sex or the same sex (Rev. Rul. 2013-17).

Community property rules apply to RDPs in NV, WA, and CA. An RDP in Nevada, Washington, or California (or a person in California who is married to a person of the same sex) must generally follow state community property laws *and report half the combined community income of the individual and his or her RDP* (or California same-sex spouse). Rewritten Pub 555 on Community Property says that RDPs may not split estimates; each must make his or her own estimated tax payments, but withholding is split. Division of property in a divorce is not taxable for opposite sex couples but can be taxable for RDPs. And the IRS states that the special rule regarding the payment of self-employment tax does not apply to RDPs or same-sex marrieds.

Preparer notes. See IRS's FAQs when filing tax returns for civil unions and RDPs.

IRS Requires Form 8958 to Allocate Community Property For Married Separate Returns (IRS Pub. 555, Rev. 2014)

The IRS created Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States. The form is used by individuals required to allocate income in community property states (e.g., married filing separately, registered domestic partners with community property rights, etc.). Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.

Form 8958 replaces worksheet from IRS Pub. In 2011 and prior years, the community property allocation worksheet from Publication 555 was used to allocate community income and deductions. While the Pub 555 worksheet provided fields to report total and spousal amounts for income items, it did not provide a way to specify the taxpayer's spouse or partner. The new Form 8958 contains all the relevant data from the Pub 555 worksheet with the addition of a location for identifying each spouse.

Marriage Penalties Abound for Married Couples

A "marriage penalty" occurs in the tax system when a couple pays more income tax filing MFJ than they would if they had remained single and filed as individuals. Conversely, a "marriage bonus" occurs if a couple pays less tax filing MFJ than they would if they were not married and filed singly.

Marriage penalties and bonuses result from the combination of progressive tax rates and taxation of a married couple as a single tax unit. With progressive taxes (which impose higher rates on higher incomes), combining spouses' incomes can result in some income incurring higher rates than if incomes were taxed separately, but only if joint tax brackets are less than twice as wide as individual brackets.

Couples in which spouses have similar incomes are most likely to incur marriage penalties. Couples in which one spouse earns all of the couple's income never incur a marriage penalty and almost always receive a marriage bonus.

> **Example.** A couple where both partners earn $100,000, having a combined income of $200,000, would experience a marriage tax penalty of $879. A couple where one partner earns $50,000 and the other $150,000, also having a combined income of $200,000, would have a marriage tax bonus of $557.

Tax legislation since 2001 has substantially reduced marriage penalties and increased marriage bonuses by raising the standard deduction for couples to twice that for single filers and by setting the income range of 10 and 15% tax brackets for couples to twice that for individuals. Legislation also raised the starting point for the EITC phaseout range by $3,000 for married couples.

Despite the recent reductions, many aspects of the tax code perpetuate penalties. For example, joint filer brackets for tax rates above 15% are not twice as wide as single brackets; income limits on some tax subsidies are less than twice as high for couples as for single filers; and alternative minimum tax (AMT) parameters for couples are the same as or less than twice those for unmarried individuals.

Taxpayers who might qualify for the earned income tax credit (EITC) can suffer particularly large marriage penalties if the income of one spouse disqualifies the other from getting the credit. At the same time, marriage can increase the EITC if a nonworking parent marries a low-earning worker.

Marriage penalties: a short list. What follows is not a complete list, but contains the most common marriage penalty areas in current federal tax law.

1. **Tax Brackets.** Although the 10% and 15% brackets have no marriage penalty, starting with the 25% bracket married filers experience brackets shifting at less than double the single amounts.
2. **AMT.** The AMT exemption amounts and AMTI limits at which the phase out of the exemption begins are not double the single levels for married couples. And the threshold at which the AMT rate changes from 26% to 28% is the same regardless of filing status.
3. **Capital Losses.** Capital losses in excess of gains are limited to $3,000 per year, regardless of filing status (except MFS).
4. **Social Security.** The base amount over which social security benefits are taxed is $25,000 (or $34,000) for singles and $32,000 (or $44,000) for marrieds.
5. **Rental Losses**. The allowance for actively managed rental real estate losses is $25,000 whether single or married and that allowance phases out beginning at $100,000 modified adjusted gross income for all (except MFS).
6. **IRA AGI Limits**. AGI limits that are not double the single amount affect a number of other items including, but not limited to: deductible IRAs and Roth IRA contributions.
7. **Earned Income Tax Credit.** Taxpayers with lower income may still see marriage penalty due to losing the earned income tax credit (EITC). As one earns more, his or her EITC rises, but as earnings rise further, the EITC phases out. According to the 2013 tables, the maximum EITC is $6,044 (with three or more children), and when earned income is above $46,227 the EITC is zero.
8. **Other individual tax credits.** Generally, tax credits are structured such that the amount of the credit falls when income exceeds a certain threshold, ultimately phasing out to zero. When marriage results in a combined income that is in a credit's phaseout range (or is so high the

taxpayers are ineligible for the credit), the credit amount may be reduced resulting in increased tax liability. Credits that are subject to income limitations include:

- # ***The Child and Dependent Care Credit***: The amount of the child and dependent care credit is limited to no more than the income of the lower earning spouse. If one spouse has no income, the couple generally would not qualify for the credit.
- # ***The Child Tax Credit***: The value of the child tax credit phases out as a taxpayer's income rises above a certain income level. The phaseout threshold for married couples is less than twice that for unmarried individuals. As a result, two unmarried individuals might each qualify for the credit but receive a smaller credit or become ineligible for it if married.
- # ***Education Tax Credits***: The income levels at which taxpayers are ineligible for education tax credits tend to be twice as high for married couples as for singles. Marriage is unlikely to affect the overall credit amount among couples whose income is equally distributed between the two partners. However, among couples whose income is less evenly distributed, the value of their education credit will depend on the income level of the individuals who incur education expenses and could increase or decrease as a result of marriage depending on the taxpayers' particular circumstances.
- # ***Adoption Credit***: The adoption credit is generally not allowed when adopting a spouse's child. Therefore, the Windsor decision may mean that some same-sex partners who might otherwise have been able to claim an adoption credit will no longer be able to do so.

New marriage penalties. Here is a list of the new marriage penalties added by the American Taxpayer Relief Act of 2012.

1. **American Taxpayer Relief Act of 2012 (ATRA)'s New Top Tax Rate.** ATRA created a new 39.6% top tax bracket, which in 2014 starts at $406,750 for single filers and $457,600 for couples filing jointly. Consider two people, each with $400,000 of taxable income. Unmarried, neither would hit the 39.6% rate. Married, they would pay the top rate on $342,400, the total income above $457,600. The rate effect would impose a marriage penalty of more than $15,750.
2. **Return of exemption and itemized deduction AGI phaseouts.** ATRA reinstated both the phaseout of personal exemptions (PEP) and the limitation on itemized deductions that the 2001-2010 tax acts had eliminated. PEP takes away 2% of personal exemptions for each $2,500 (or part thereof) above a 2014 threshold—$254,200 of AGI for singles and $305,050 for couples. PEP wouldn't affect an unmarried couple in which each person has $254,200 of AGI but would take away all of their personal exemptions if they were married. That could increase their tax bill by more than $1,500 for each person in their family. The 3% AGI phaseout reduces itemized deductions by 3% of AGI over the same thresholds that apply for PEP. It wouldn't affect the unmarried couple with each person having $254,200 of 2014 AGI but would raise their taxable income by up to $6,000 if they married, adding as much as $2,376 to their tax bill.
3. **Affordable Care Act Taxes.** Two new taxes associated with the 2010 Healthcare Act took effect in 2013: a 0.9% tax on earnings over unindexed thresholds—$200,000 for singles and $250,000 for couples—and a 3.8% tax on net investment income over those thresholds. Two people earning $200,000 each would not pay either tax. If they marry, they would pay between $1,350 (if their income is all wages) and $5,700 (if it's all investment income) in new Medicare taxes.

Marriage bonuses. Here are a few of the benefits available from the married filing status.

1. **Excluded gain on sale of residence.** For married couples where only one is on title to the house,

sale of the residence will be allowed the married exclusion under §121 of $500,000 instead of only $250,000. In addition, a surviving spouse will be allowed up to two years to dispose of the residence and retain the $500,000 exclusion.

2. **Excluded employer-provided health insurance.** Married couples do not pay income taxes on the value of employer provided insurance to an employee's spouse. This is a new tax benefit for same-sex couples.
3. **Dependent care Flexible Spending Accounts.** The Windsor decision will affect whether certain forms of employee compensation are nontaxable, including contributions to dependent care flexible spending accounts (DCFSA) and the employer contributions for employer-provided health insurance plans. Taxpayers with children may contribute up to $5,000 to a DCFSA. The total amount of contributions that are tax exempt for any tax return is $5,000 without regard to the number of children or the number of parents. Any amount in excess of $5,000 would be included in taxable income for the married couple. Same-sex married couples who each have contributed to a DCFSA may find that part of their account becomes taxable even though their individual incomes make them eligible for the child and dependent care credit. If each partner had a child and each was contributing to a DCFSA, they may have over-contributed in the first year in which they file as a married couple. In subsequent years, they would be limited to putting $5,000 in the DCFSA, though they could divide that amount between themselves.
4. **Estate and gift taxes.** A taxable "estate" (the money and assets of the deceased person) may take an "unlimited marital deduction." This means that, essentially, the estate will not incur any estate tax liability with respect to any assets left by the deceased spouse to his or her surviving spouse. The "marital deduction" effectively permits married couples to postpone federal estate tax that otherwise would have to be paid on the deceased's estate because the property passing to the surviving spouse will not be taxed until the surviving spouse's death. Under DOMA, no marital deduction was available to same-sex couples, and the value of the assets left to a same-sex spouse was fully included in the taxable estate.

   Planning idea. When one spouse dies in a community property state, if properly titled, all assets will receive a complete step-up in basis.

No Going Back to Married Filing Joint (MFJ) after Filing as Head of Household (HOH) (*Isaak Abdi Ibrahim v. Comm.*, TCM 2014-8)

Isaak Ibrahim lived in Minneapolis with his spouse Rukia Hassan and four children. Based on advice from Oday Tax Service, whom he paid to prepare his tax return, Isaak claimed HOH filing status and Rukia filed as a single taxpayer.

Head of household filing status. Since Isaak and Rukia were legally married at the close of tax year 2011, Isaak's correct filing status was married filing separately and the MFJ filing status was not available.

Trap! No going back to MFJ at Tax Court. Individuals who file a "separate return" for a taxable year in which they could have filed a joint return may amend their return and elect joint filing status (§6013(b)). However, changing to MFJ filing status is ***NOT*** allowed after (1) 3 years from the due date of the return (determined without regard to any extension of time granted to either spouse) or (2) either spouse is mailed a notice of deficiency under §6212 and the spouse, as to such notice, files a petition with the Tax Court

EIC Epithet. To be considered an eligible individual for EIC purposes, a married taxpayer must file a joint return. Because Isaak was married in 2011, but was prohibited from filing a joint return, he was not allowed to claim EIC. Moral of the story, hire a competent tax professional!

PERSONAL EXEMPTIONS AND DEPENDENTS §151 - 153

The 2014 Personal Exemption is $3,950 ($3,900 in 2013) (Rev. Proc. 2013-35)

Personal Exemption Phaseouts for High Income Taxpayers (Rev. Proc. 2013-35, Sec. 3.23)

In 2012, all taxpayers were allowed to deduct 100% of their personal exemption deductions for regular income tax purposes. Beginning in 2013, personal exemption deductions are phased out for high income taxpayers. The phaseout is equal to 2% of the exemption for each $2,500 (or fraction thereof) of AGI in excess of a threshold amount (resulting in a $122,500 phaseout range). The 2014 AGI threshold amounts are:

Filing status	AGI to begin phaseout*	AGI when fully phased out
Married filing joint	$305,050	$427,550
Head of household	$279,650	$402,150
Single	$254,200	$376,700
Married filing separate	$152,525	$213,775
* AGI phaseout amounts are annually adjusted for inflation.		

Example. Amanda and John have two children. Their 2014 exemption deduction is $15,800 ($3,950 x 4). If Amanda and John's 2014 AGI exceeds $427,550, the phaseout would result in additional tax of $5,530 (assuming a 35% tax bracket).

Preparer note. The phase out of personal exemptions increases the marginal tax rate for those in the phaseout zone by as much as 1.05% for *each* exemption.

DEFINITION OF A QUALIFYING CHILD AND QUALIFYING RELATIVE

Definition of a "Qualifying Child" Five Tests must be Satisfied (§152(c))

1. **Child must be related to taxpayer** §152(f)(1)).
2. **Age**. The child must not have attained the age of 19 by the end of the calendar year or must be a student that has not attained the age of 24 by the end of the calendar year (§152(c)(3) and (f)(2)) and must be younger than the taxpayer (§152(c)(3)(A)). Exceptions to these requirements exist for any individual who is totally and permanently disabled at any time during the year (§152(c)(3)(B)).
3. **Child must have same principal place of abode as taxpayer for more than ½ of year** (§152(c)(1)(B)).

4. **Child must not provide more than ½ of his or her support for year** (§152(c)(1)(D)).
5. **Joint return restriction**. The child must not have filed a joint return (other than for a claim of refund only) (§152(d)(1)(E)).

#1: Children of Cousin Do Not Qualify for the Child Tax Credit (*La Tashia Gentry, pro se v. Comm.,* TCM 2013-16)

On her 2008 income tax return, La Tisha Gentry claimed her first cousin's two children as dependents and claimed child tax credits of $1,950 (after AGI limits applied). The children lived with Ms. Gentry the entire year, and she provided more than ½ of their support.

Children of cousin are not "qualifying children" of the taxpayer. A qualifying child (as defined under §152(a)) must be the taxpayer's child, brother, sister, stepbrother, or stepsister, or a descendant of such relatives (§152(c)(2)). A qualifying relative, however, may be an individual who, for the year in issue, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household, and for whom the taxpayer provides over one-half of the support (§152(d)(1)(C), (2)(H)). The children were Gentry's "qualified relatives," not her "qualifying children." Ms. Gentry was entitled to claim the dependency exemptions, but could not claim the child tax credits.

#4: Student Loan Considered Part of Support Provided by Child (*Douglas Lemark Burse v Comm. pro se*, TCS 2014-21)

Child must not provide more than ½ of her support for year (§152(c)(1)(D)). Douglas Burse married Tara Riley Burse. Tara had a daughter, T.R., from a previous relationship, and Doug was T.R.'s stepfather. Doug and Tara filed separate tax returns with Doug claiming T.R. as a dependent and filing head of household status. The court determined that although T.R.'s income from employment was minimal at best, she received loans to finance her education. Student loan proceeds count as support furnished by the student, and not a parent, if the student is obliged to repay the loan (*McCauley v. Comm*., 56 T.C. 48, 49 (1971); see also *Williams v. Comm.*, T.C. Memo. 1994-63). Therefore, the amounts that T.R. received as student loans were considered support that she provided for herself. The Court could not conclude that T.R. did not provide over one-half of her own support for 2011 resulting in T.R. being neither Doug's qualifying child nor his qualifying relative.

Definition of "Qualifying Relative" (§152(d))

Individuals not qualifying as a "qualifying child" may still be claimed as a dependent if four tests are satisfied:

- ***The relative must be related to the taxpayer*** §152(f)(1)) ***OR***, have the same principal place of abode as the taxpayer for the tax year and is a member of the taxpayer's household.[1]
- ***Gross income***. The individual's gross income for the calendar year must be less than $3,950 in 2014.
- ***Support***. The taxpayer must furnish over half of the dependent's total support for that calendar year.

[1] Interestingly, this class of "qualified relative" has no family relationship to the taxpayer. However, an individual is not a member of the taxpayer's household if the relationship between the individual and the taxpayer violates local law (§152(f)(3)).

\# *Dependency*. The individual must not be the qualifying child of the taxpayer or of any other taxpayer for the tax year. When the "other taxpayer" is not required to file an income tax return and does not file an income tax return, or files an income tax return solely to obtain a refund of withheld income taxes, the dependent relative may be claimed by another (Notice 2008-5).

Mother of Fiancé is Taxpayer's Dependent (*John K. Edge v. Comm. pro se*, TCS 2013-68)

An individual is a qualifying relative if the individual, although unrelated by blood or marriage to the taxpayer, has the same principal place of abode as the taxpayer ***and*** is a member of the taxpayer's household for the taxable year (§152(d)(2)(H)).

IRS agent denied dependency exemption because Mother took a two-week vacation - Court disagreed. John Edge, a Louisiana cook and part time construction worker, claimed Sharon Rodgers, his fiancé's mother, as a "qualifying relative." The IRS denied it because she allegedly did not reside in John's household at the end of December. Sharon traveled to Florida for a Christmas holiday vacation on or around December 13, 2011, returning around December 28, 2011, but moved out of his home a few days later. The court found vacation days are included, not excluded, when determining if the taxpayer is a member of the household for the "entire" taxable year. Therefore, the court held that Sharon was a qualifying relative and John was entitled to a dependency exemption deduction with respect to her for 2011.

Tie-Breaking Rules for Qualifying Child (§152(c)(4))

A child who may be claimed as a qualifying child by two or more taxpayers for a taxable year will be treated as the qualifying child of the taxpayer who is a parent of the individual, or if not a parent, the taxpayer with the highest adjusted gross income for such taxable year, ***EXCEPT:***

1. If both parents claim a qualifying child, the child will be treated as the qualifying child of the parent with whom the child resided for the longest period of time during the taxable year, or if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income (§152(c)(4)(B)(i) & (ii)).
2. If the parents of an individual may claim such individual as a qualifying child, but no parent claims the individual, such individual may be claimed as the qualifying child of another taxpayer, but only if the adjusted gross income of the other taxpayer is higher than the highest adjusted gross income of any parent of the individual (§152(c)(4)(c))).

Court Determines Who May Claim Children when Married Filing Separate but Living Together the Entire Year (*David M. Kososki v. Comm. pro se*, TCS 2014-28)

Wife first filed jointly and then refiled separately. During 2010, David and Nicole Kososki lived together as husband and wife with their two children. Shortly after their 2010 married filing joint return was filed, Nicole and the children moved out of the marital home and timely filed a married filing separate return, claiming both children.

The back story. On February 4, 2011, David, with assistance from his mother, electronically filed the 2010 tax return as married filing jointly. The joint return reflected an overpayment and a claim for credits resulting in a refund due of $7,768. The refund was directly deposited into David's bank account in which Nicole was not a named account holder. After moving out, Nicole said she didn't object to filing a joint return, but expected to receive a portion of the refund from David. In March 2011 Nicole learned that David had received the tax refund and refused to share any of the refund. In response, in late March 2011, Nicole filed a married filing separate tax return for 2010, claiming the dependency exemption deductions for their two children.

Is Nicole entitled to the dependency exemption for the children? As David and Nicole did not separate until 2011, the two children lived in the same household as both parents, with the court exclaiming "It would thus appear initially that the children are the qualifying children of each parent." But, the court pointed out, "when the qualifying child resided with both parents for the same amount of time during the taxable year" and " . . . the parents claiming any qualifying child do not file a joint return together, such child shall be treated as the qualifying child of * * * (ii) * * * the parent with the highest adjusted gross income" (§152(c)(4)(B)). In this case, that was Nicole.

> **Tax tip.** Nicole received smart tax advice!

Can Nicole file an MFS return after she and her husband filed MFJ? Where spouses file a joint return with respect to a tax year, neither spouse may thereafter elect married filing separately status for that tax year if the time for filing the tax return of either spouse has expired, generally, April 15th (§6072(a)). Therefore, because Nicole filed as married filing separately before the time for either spouse to file a return had expired, her separate return was valid (§1.6013-1(a)(1)). Since Nicole filed a separate return after the joint return, and the IRS accepted it, the IRS adjusted David's original joint return to married filing separately status. The court agreed.

> **That will teach you to be greedy!** Therefore, David was not entitled to the earned income credit and the additional child tax credit since he was not allowed a dependency exemption deduction for either child.

DEPENDENCY RULES FOR CHILD OF A DIVORCED COUPLE

Children of Divorced or Separated Parents or Parents Who Live Apart

In most cases, because of the residency test, a child of divorced or separated parents is the qualifying child of the custodial parent. The *custodial parent* gets the exemption.

Who is the Custodial Parent after a Divorce or for the Unmarried Parents? (§152(e); §1.152-4)

Custodial parent is determined by a "time" test. A qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year. In addition, the parent(s) must have the right under state law to physical custody for more than one-half of the taxable year; e.g., if Grandmother has the right under state law to physical custody of a child from January 1 to July 31, neither parent can use the special dependency rules for divorced parents and only the regular dependency rules will determine if Grandmother or either parent can claim the child (§1.152-4((c); §1.152-4(g), Exp. 3). If both parents claim a child as a qualifying child and do not file a joint return, the child is the qualifying child of the parent with whom the child resides for the longer period of time (i.e., nights over) during the taxable year or, if the child resides with both parents for an equal period of night overs, of the parent with the higher adjusted gross income (§152(c)(4)(B); §1.152-4(a); §1.152-4(d)(4)).

The "counting nights over" rule: custodial parent determined by majority of child's "night overs," not by divorce decree. The custodial parent is the parent with whom the child resides for a greater number of nights during the calendar year. The other parent is designated the noncustodial parent (§1.152-4(d)(1)). This "time" test reverses the prior §1.152-4(b), which stated that "the term 'custody' was 'determined by the terms of the most recent decree of divorce'" (see §1.152-4(b); *Cafarelli v. Comm.*, TCM 1994-265).

See also: *Timothy Holmes* TCS 2013-32, where even though the parents shared custody, father lost exemptions for his children because he couldn't prove that he had the children for more than ½ of the year and the divorce decree granted "primary physical residency" to the mother.

A Court Order, Decree, or Separation Agreement May Not Serve as the Written Declaration (§1.152-4(e)(1)(ii); CCA 200925041).

Starting on July 2, 2008, neither a court order or decree nor a separation agreement, by itself, can serve as a qualified written declaration.

> **Preparer note.** The regulations grandfathered in pre-7/2/2008 court orders, decrees, and separation agreements, and they will be treated as meeting all of the requirements of a qualified written declaration as long as they satisfy *all* the requirements for releasing a child (1.152-4(e)(5)).

State Family Court Claims Authority to Allocate Dependency Exemptions (*Phalla Iv v. Samath Hang*, Massachusetts Appeals Court; 11-P-2181, May 14, 2013)

Custodial mother says court has no right to decide deductions. Phalla Iv and Samath Hang married in 2004 and divorced in 2011. Phalla, the wife, was awarded physical custody of the couple's two children, and Samath, the husband, was ordered to pay child support of $228 per week. Furthermore, the family court ordered that Samath was entitled to claim both children as dependents on his Federal and State income tax returns. Phalla argued that Federal tax law preempts state courts from making awards of dependents.

Further control given to custodial parents in recent tax law changes. Under current Federal tax law, a noncustodial parent may *only* claim a child as a dependent if the custodial parent signs a written declaration agreeing that he or she will not claim such child as a dependent for the taxable year and the noncustodial parent attaches such a written declaration to his or her tax return. Any court order, decree or separation agreement entered into after July 2, 2008, may not serve as a written declaration.

Custodial mother claims state family court has no jurisdiction. Phalla argued that the present Federal system of dependency exemptions and credits does not allow State courts to make awards of dependency exemptions and that even if a divorce decree requires a parent to sign Form 8332, such orders are ineffective to allocate the right to claim the child as a dependent. She further argued that the state judge's order awarding the husband the right to claim the children was unlawful and she was entitled to claim both children as dependents.

State court says "*do what we tell you to do or else*!" In *Bailey*, the court determined that a state judge has authority to allocate dependency exemptions and that its authority to do so was not abrogated by subsequent §152 amendments. In the case at hand, the state court found that the general holding in *Bailey* continues to have vitality and that there is nothing in the statute or regulations that prevents a state court from allocating dependent exemptions or ordering the custodial parent to execute the appropriate form releasing the custodial parent's right to the exemption. While the Court acknowledged that Federal law pertaining to the release of the exemption must be complied with, it ruled that there is nothing in the regulations that would preclude a state court from allocating an exemption (or ordering that a custodial parent execute an appropriate form releasing the exemption) and ***then enforcing that order on the state level through a contempt proceeding***.

Custodial Parent Can Release Exemption for Child to the Noncustodial Parent
Eligibility requirements to release. The noncustodial parent is allowed to claim a dependency exemption deduction for a child *only*:

6. If the custodial parent signs a written declaration that the custodial parent will not claim the child as a dependent for any taxable year *and*
7. the noncustodial parent attaches the declaration to his or her return (§152(e)(2)).

Comment. Joint custody must use the general "night over" custody rules.

Release must be attached to noncustodial parent's return. A noncustodial parent must attach a copy of the original written declaration for *each* taxable year in which the child is claimed as a dependent (§1.152-4(b)(3)(i); §1.152-4(e)(2)).

Noncustodial Parents Denied Dependency Exemptions and Child Tax Credits; No Signed Form 8832 (*Billy Edward Armstrong; Phoebe J. Armstrong v. Comm.* (CA-8) 13-1235; *David Matthew Hanson; Melinda D. Hanson v. Comm.*, 13-2064, 2014-1 USTC ¶50,211; March 13, 2014)

Divorce decree grants child exemption to noncustodial father if current on child support. In a consolidated appeal, two divorced fathers, Billy Armstrong and David Hanson, submitted documents in which ex-wives agreed that each were entitled to the exemptions in any year they were current with their child support obligations. It was undisputed that they were current in the tax years in question. Therefore, Billy and David argued, the documents submitted in lieu of a Form 8332 signed by the custodial parents "conform[ed] to the substance" of Form 8332, and they were entitled to the dependency exemption and child tax credit.

Where was the statement that the custodial parent "will not claim" the children? The court disagreed, stating §152(e)(2) "provides that a noncustodial parent may claim the child as a dependent if he or she attaches to the tax return a written declaration signed by the custodial parent and declaring that the custodial parent 'will not claim such child as a dependent' in that calendar year. A conditional declaration simply does not meet this requirement."

Court clearly states that state agreements do not impact federal law and the remedy is to go back to state court. The state law creates legal interests but the federal statute determines when and how they shall be taxed" (*US v. Mitchell*, 403 U.S. 190, 197 (1971) (quotation omitted)). "Determining who is entitled to federal income tax exemptions, deductions, and credits is entirely a matter of federal law, for these are questions of 'when and how they shall be taxed.'" "Of course, if a violation of a state court order wrongly deprives the intended beneficiary of a federal tax advantage, the state court unquestionably retains authority to remedy that violation." "But Congress in the 1984 amendment to §152(e)(2) precluded attempts to remedy such wrongs in federal income tax proceedings."

Preparer warning. Always advise that your client seek legal advice before claiming on his or her return a child's dependency exemption that WAS awarded by the divorce court to the other parent. Contempt of court is serious.

Release Only Transfers Dependency Exemption and Child Tax Credit

Form 8332 only releases the dependency exemption, the $1,000 child tax credit and the additional child tax credit to the noncustodial parent (see §24(a), clarified by H.R. 6893 for tax years beginning in 2009). The custodial parent retains the right to claim head of household filing status, the earned income credit and dependent care credit, if eligible.

Revocation provided on Form 8332. See Part III of the form 8332 and its instructions for guidance.

CAPITAL GAIN AND DIVIDENDS

0% and 15% Rates for Capital Gains and Dividends Made Permanent For Most, But High Income Taxpayers Subject to 20% Rate (American Taxpayer Relief Act of 2012 (P.L. 112-240))

The long-term capital gains and qualified dividend tax rates for taxpayers below the 25% bracket are zero percent. For those above the 15% bracket but below the 39.6% bracket, the long-term capital gains and qualified dividend tax rates are 15%. For those in the 39.6% ordinary tax bracket the long-term capital gain and qualified dividend tax rate is 20% in 2013 and later years. This treatment applies for purposes of both the regular tax and the alternative minimum tax. These rates have all been made permanent.

Ordinary Tax Bracket	1/1/2001 - 5/5/2003	5/6/2003-2007	2008-2012	2013 and beyond
10% and 15%	8% /10%	5%	0%	**0%**
25% to 35%	20%	15%	15%	**15%**
39.6%	NA	NA	NA	**20%**

Other capital gains rules same. No rate reduction occurred on the maximum 25% rate on depreciation recapture, the 28% rate on collectibles (such as gold and silver) and the net gain rules on small business stock. In addition, net capital losses are still subject to the $3,000 annual limit.

2014 Planning Ideas for Lower Capital Gains and Dividend Rates

1.Hold stock for long-term gains because the spread between short-term and long-term gains is as high as 19.6%.
2.Gift appreciated stock to adult children or parents in low brackets to utilize the 0% tax rate.
3.Closely held corporations may still pay out dividends at capital gain rates. Isn't this the time to clear some old shareholder loan amounts to a dividend?
4.AMT often makes the effective long-term capital gain rate higher than 15%/20%. And, of course, state tax makes the rate higher than "advertised."

Tax Foundation Reports Capital Gains Tax Rate Creates Tax Bias against Savings (The High Burden of State and Federal Capital Gains Tax Rates, by Kyle Pomerleau of Tax Foundation, February 11, 2014)

Currently, the United States' top marginal tax rate on long-term capital gains income is 23.8%. In addition, according to the Tax Foundation, taxpayers face state level capital gains tax rates as low as zero and as high as 13.3%. As a result, the average combined top marginal rate in the United States is 28.7%. This rate exceeds the average top capital gains tax rate of 18.2% faced by taxpayers throughout the industrialized world. Even more, taxpayers in some states face top rates on capital gains over 30%, which is higher than most industrialized countries. In fact, California's top marginal capital gains tax rate of 33% is the third highest in the industrialized world, while taxpayers in states without taxes on capital gains, such as Florida, Texas, South Dakota, and Wyoming, face top rates higher than the OECD average.

IRS Takes a Stand: Bitcoin is Anything but 'Currency' (Mark Schwanhausser, Javelin Strategy and Research, with permission(March 25, 2014))

The Internal Revenue Service sounded a loud warning shot today for all you Bitcoin users: Stop calling it a virtual "currency." In the eyes of the taxman, it's anything but – and that means taxpayers now must confront a raft of ways in which Bitcoin must be reported and taxed.

In a wide-ranging Q&A, the IRS laid out a number of other ways that Bitcoin can be taxed – as an asset, as income, as payment in property, as a transaction, even as self-employment income by all those "miners." No matter which approach applies, every one puts the onus on some player to report Bitcoin activities to the IRS — creating a paper trail that enables the taxman to perform the simplest of computerized matching to generate letter "audits" asking taxpayers to explain why they failed to report a taxable event.

The IRS stance builds on the assumption that Bitcoin is not a currency for a simple reason: "It does not have legal tender status in any jurisdiction." That then sets of a cascade of practical questions for individual taxpayers, "miners," small businesses, brokerages, and other players to confront. For example:

• Are you paying employees in Bitcoin? Then pay attention to the employment taxes and withholding requirements for things like FICA – and kick out a W-2 at year's end.

- Are you paying a contractor more than $600 in Bitcoin? Then kick out a 1099 so the IRS can ask the recipient about their unreported income, and backup withholding could apply.
- Are your hands grubby from tunneling in search of Bitcoin? That could constitute a trade or business and be subject to self-employment income.
- Are you cashing in your Bitcoin at an exchange or through a brokerage? Then you should receive tax-filing reports at the end of the year, and then the IRS will examine your capital gain or loss.
- Are you settling payments between merchants? Then you've got to tell the taxman who you dealt with.

And here's the concluding warning from the IRS: Penalties could apply retroactively, not just from March 25 onward. So, be on notice all you speculators who profited as Bitcoin jumped nearly tenfold to more than $1,100 in November. The IRS – and probably your state, too – want a share.

Sales Manager Reported Income as a Sale of Asset (Capital Gain) but IRS Recharacterized it as Providing Services (Ordinary Income) (*Scott and Eresia Kamieneski v. Comm. pro sese*, TCS 2014-22)

Sales manager develops "client engagement methodology." Shortly after being laid off from Symcon Global Technologies (SGT) and beginning work for Oracle Corp, Scott Kamieneski offered to develop for SGT certain business model and practice innovations in the form of an "improved client engagement methodology." This client methodology was designed to assist small to medium-sized businesses to implement excellence by taking a comprehensive, strategic approach to the life cycle of a business or product which Scott called LABS, for Learn, Analyze, Assess and Adapt, Build and Scale. Scott did not apply for, nor obtain, a copyright or patent for the client methodology.

"I sold a capital asset." No, you didn't, you provided services. Scott received $11,250 in 2009 pursuant to the agreement with SGT but didn't report it. The IRS issued a notice of deficiency on the unreported $11,250, characterizing it as "nonemployee compensation" taxable as ordinary income. Scott did not contest receipt of the $11,250 but asserted that it was capital gain and not ordinary income.

Is the development of intellectual property a capital asset? Not if it is a "license to use"! Capital gain results from gain on the sale or exchange of a capital asset (see §1222). But, for a transaction to receive capital gains treatment, the property which is transferred must be sold or exchanged. In order for the transfer of the client methodology to be deemed a sale for tax purposes, the court examined if Scott surrendered "all substantial rights" of value in the client methodology; otherwise, the transfer would be deemed a license requiring the gains from the transaction to be taxed as ordinary income.

The difference hinged on "conferring exclusivity." Interestingly, the court concluded that Scott did not grant SGT exclusivity in the client methodology because the contract didn't specifically confer exclusivity. The agreement contained no terms preventing Scott from disclosing the client methodology to other persons or entities. Therefore, the court held the client methodology did not amount to a sale and the remuneration Scott received was considered ordinary income.

Other Capital Gain/Loss Reporting Issues

Form 1099-B includes Basis Reporting (Proposed Regulations, NPRM REG-154563-12, 2013FED ¶49,571)

Brokers historically have been required to file Form 1099-B to report the gross proceeds from the sale of stocks, bonds, mutual funds, T- Bills (if sold before maturity), and certain commodities (§6045(a)). Beginning Jan. 1, 2011, brokers subject to §6045(a) must also include on Form 1099-B the taxpayer's adjusted basis of securities sold and disclose whether any respective gains or losses are long-term or short-term for "covered securities" (§6045(g)). Form 1099-B now includes boxes for the date of acquisition, stock or security symbol, quantity of shares sold, cost or other basis, amount of loss disallowed due to wash sales, whether the property sold is a covered or noncovered security, and whether the gain or loss is short or long-term.

Basis reporting for debt instruments and options begins in 2014 (Notice 2012-34). Originally the applicable date for other specified securities (debt instruments, options, etc.) was January 1, 2013 (§6045(g)(3)(C)). However, the IRS postponed basis reporting so that only debt instruments and options acquired on or after January 1, 2014, will be covered securities for basis reporting purposes.

How is Basis Calculated (§6045(g)(2)(B))?

Identification of securities. If a taxpayer has acquired securities on different dates or at different prices and sells less than the entire position in the security, the broker reports the sale according to the taxpayer's adequate and timely identification of the security to be sold. If no identification is provided, the sale is reported in this order:

1. Any shares for which the acquisition date is unknown; then
2. The shares that were acquired first, whether they are covered or noncovered securities.

Proposed regulations allow standing orders for basis determination (NPRM REG-101896-09). Taxpayers may wish to specifically identify to their brokers which securities are being sold by issuing a standing order to use a specific identification method such as last-in-first-out (LIFO) or highest-in-first-out (HIFO). The proposed regulations clarify that taxpayers may establish specific lot selection by using such standing orders.

> **Planning idea.** Investors may find the LIFO or the HIFO accounting methods more advantageous, but such methods must be communicated to brokers before affected securities are sold. Alternative costing methods may not be selected once the security is actually delivered to the buyer (Rev. Rul. 67-436, NPRM REG-101896-09).

Other Basis Reporting Issues

Brokers must share basis if account transferred. Any broker who transfers a specified security to a new broker after 2010 (2011 if the stock is a regulated investment company) must provide the new broker a written transfer statement within 15 days after the date of settlement for the transfer which must include a separate statement for each transferred security and, if transferring custody of the same security acquired on different dates or at different prices, for each acquisition.

Transfer statement must be provided when securities received via inheritance or gift. Estate executors must provide to estate beneficiaries a transfer statement that includes the decedent's date of death and the description, basis, and the executor's valuation for the security(ies) transferred. Those making a gift of a security must provide a transfer statement to the gift recipient disclosing the donor's purchase date and basis in the security(ies) transferred.

Reporting of Long-Term and Short-Term Capital Gain or Loss

Schedule D is generally summary reporting. Schedule D and D-1 have largely been replaced by Form 8949. Schedule D has essentially become a total form summarizing the gains or losses reported on Form 8949, although Schedule D is still used to report undistributed long-term capital gain from Form 2439, installment gains from Form 6252, recapture income from Form 4797, casualties and thefts from Form 4684, Section 1256 contracts and straddles from Form 6781, like-kind exchanges from Form 8824, gains or losses from a partnership, S corporation, an estate or trust, and capital loss carryovers from prior years.

Some transactions can be reported on the Schedule D without using the Form 8949. You can report on line 1a (for short-term transactions) or line 8a (for long-term transactions) the aggregate totals from any transactions (except sales of collectibles) for which: the taxpayer received a Form 1099-B that shows basis was reported to the IRS and does not show a nondeductible wash sale loss in box 5, and the taxpayer does not need to make any adjustments to the basis or type of gain or loss (short-term or long-term) reported on Form 1099-B, or to the taxpayer's gain or loss.

Form 8949 is used to report:

1. Detail reporting of short- and long-term capital gain or loss transactions (except as noted above where basis is reported to the IRS);
2. The sale or exchange of capital assets not reported on other forms or schedules (e.g., Form 4797);
3. Gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit; and
4. Nonbusiness bad debts.

Exception to Reporting Each Transaction on a Separate Line (see Schedule D Instructions)

Instructions for Form 8949 require taxpayers to report each individual security sale during the year. Entering "available upon request" and summary totals in lieu of reporting the details of each separate transaction is not allowed. Taxpayers may, however, attach a statement that reports each separate transaction and all the same information required by Form 8949 to a paper filed return or, if e-filing, to Form 8453. If you have statements from more than one broker, or if you have more than one account with the same broker, report the totals from each broker and/or account on a separate line of Form 8949. Numerous attachments are allowed (i.e., one or more from each broker or account). The combined totals from all attached statements are then reported on Form 8949 with the appropriate box checked.

Tax Preparers Left with 4 Options

1.Enter each individual transaction reported on Form 1099-B;
2.Use the realized gain/loss reports supplied by the broker or investment manager with your own subtotals. Attach the data to a paper filed return or as an attachment to Form 8453 if e-filing. Most software programs now allow the pdf of the broker statement to be attached to the e-file return.
3.Purchase conversion software to convert pdf documents into an spreadsheet. Once the pdf information is imported into a spreadsheet it is relatively simple to manipulate and move items to match the required reporting.
4. Download broker information and export it to your software.

Other Form 8949 Adjustments

Wash sales (§1091). A wash sale occurs when a taxpayer sells or trades stock or securities at a loss and within the 30 days before or after the sale (1) buys substantially identical stock or securities, (2) acquires substantially identical stock or securities in a fully taxable trade, or (3) acquires a contract or option to buy substantially identical stock or securities (§1091(a); §1.1091-1).

Losses from sales or trades of stock in a wash sale may not be deducted. Disallowed wash sale losses are added to the cost basis of the acquired stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities. The holding period of the new stock begins on the same day as the holding period of the stock sold (§1223(4); §1.1223-1).

Bad Debt

Requirements for a bad debt deduction: A deduction is allowed for any debt that becomes worthless within the taxable year (§166(a)(1)). The inability to collect money due to a breach of contract *may* allow the taxpayer a bad debt deduction. But prior to taking the deduction, the taxpayer must determine:

1. Is the debt actually worthless?
2. Is it genuinely a “bona fide” debt?
3. Is the debt factually a capital contribution?
4. Is the debt a business bad debt?
5. Is the debt a nonbusiness bad debt?

Reporting the bad debt on the tax return: Now reportable on Form 8949, when specific debts are deducted, there must be an explanatory statement attached to return, showing:

1. the nature of the debt (including the amount),
2. the name of the debtor and any business or family relationship to the taxpayer,
3. the date the debt became due,
4. the efforts made to collect the debt, and
5. the reason for determining the debt to be worthless (IRS Pub. 17, p. 128).

Planning Points for Showing Worthlessness 1.Secure a copy of the promissory note and payment records. 2. Show when payments stopped (or failed to begin) and action was taken to collect. 3. Don't hold off on claiming the bad debt deduction until a capital gain shows up. 4. Consider selling the note to an unrelated third party.

SOCIAL SECURITY (FICA) PAYMENTS

FICA and SE Tax Update Chart	2013	2014	2015
Maximum FICA (OASDI) Wage Base	$113,700	**$117,000**	
FICA/Medicare Tax Rate 6.2% (4.2% in 2012) + 1.45%	7.65%	**7.65%**	7.65%
SE Tax Rate	15.3%	**15.3%**	15.3%
Maximum Medicare Wage Base	Unlimited	**Unlimited**	Unlimited
Medicare Rate	1.45%	**1.45%**	1.45%
Earned Income Ceilings for Social Security Benefits < Full Retirement Age	$15,120	**$15,480**	
Medicare B Premium	$104.90/mo $1,259 to $4,028	**$104.90/mo $1,259 to $4,028**	

Medicare B & D Premium Surcharge in 2014

Surcharge on Medicare D premiums. Beginning in 2007, Medicare Part B premiums were means tested. First-year retirees are often hit with the increased premium because wages in the year of retirement boost that year's AGI. In 2011, means testing also began for Medicare D premiums.

To determine if a Social Security recipient is required to pay the premium surcharge for 2014, a "modified adjusted gross income" for 2012 must be calculated as follows:

1. The Social Security recipient's 2012 adjusted gross income.
2. Plus any tax-exempt interest, EE bond interest used for educational purposes, and any excluded foreign earned income.

2014 Medicare B and D Premiums

Individual	Married

If your 2012 AGI is	2014 monthly Part B premium	2014 monthly Part D surcharge	If your 2012 AGI is	2014 monthly Part B premium	2014 monthly Part D surcharge
Under $85,000	$104.90	$0.00	Under $170,000	$104.90	$0.00
$85,000-$107,000	$146.90	$12.10	$170,000 - $214,000	$146.90	$12.10
$107,000-$160,000	$209.80	$31.10	$214,000-$320,000	$209.80	$31.10
$160,000-$214,000	$272.70	$50.20	$320,000-$428,000	$272.70	$50.20
$214,000+	$335.70	$69.30	$428,000+	$335.70	$69.30

Disputing the surcharge. The surcharge results in higher income taxpayers paying 80% of the government's Medicare premium cost. Social Security recipients will have an opportunity to dispute the surcharge determination and use income from a later year if their circumstances change due to a major event such as death of a spouse, divorce, retirement, or a significant cutback in hours worked.

Social Security Disability Benefits are Taxable (*John Barefield, pro se v. Comm.*, CA-11, 2013-1, No. 12-13312, Jan. 13, 2013))

John Barefield did not include Social Security benefits he received in his taxable income because the benefits were paid to him as a result of his disability. The court noted that the taxability of Social Security benefits does not change regardless if benefits paid are disability benefits or old age insurance benefits (§86). Starting in 1984, Social Security disability benefits are treated in the same manner as other Social Security benefits and are subject to tax pursuant to §86.

INCOME FROM SOURCES OUTSIDE THE U.S. & THE FOREIGN INCOME EXCLUSION (§911)

Foreign Earned Income Exclusion (§911; Pub 4732)

A qualified individual may elect to exclude, subject to limitations, foreign earned income and foreign housing costs from gross income. "Foreign earned income" is defined as the amount received by an individual from sources within a foreign country which constitute earned income attributable to services performed by the individual. The term "qualified individual" means an individual whose ***tax home*** is in a foreign country ***and*** who is:

1. a citizen of the U.S. and establishes that he or she was a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or

2. a citizen or resident of the U.S. and who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period.

Thus, a taxpayer must ***both*** (1) maintain a tax home in a foreign country, ***and*** (2) either (a) establish a bona fide residency for an entire taxable year, or (b) be present in a foreign country during at least 330 full days in a 12-month period.

Waiver exceptions allowed in some cases. Individuals who fail to meet the 330-day physical presence test may be treated as a qualified individual if he or she is eligible for a waiver. Waivers may be issued to individuals who:

1. were bona fide residents of, or were present in, a foreign country for any period during which individuals were required to leave such foreign country because of war, civil unrest, or similar adverse conditions which precluded the normal conduct of business by such individuals; ***and***
2. were able to establish to the IRS that the time requirements of the foreign earned income exclusion could reasonably have been expected to have been met but for the conditions of war, civil unrest, or similar adverse conditions.

    Preparer note. The Secretary publishes a list of foreign countries where war, civil unrest, or similar adverse conditions exist for purposes of §911(d)(4)(B) for years in which such conditions exist.

2014 exclusion amounts. For qualified individuals in 2014 (Rev. Proc. 2013-35):

1. The foreign earned income exclusion is $99,200 in 2014 ($97,600 in 2013).
2. The foreign housing cost exclusion is $13,888 ($99,200 x 14%) ($13,664 in 2013).

Housing exclusion is increased in some high cost areas. Due to the high cost of living in some cities, determined to be over $29,760 ($99,200 x 30%) in 2014 ($29,280 in 2013), higher foreign housing exclusions are allowed. See Notice 2013-31, Determination of Housing Cost Amount Eligible for Exclusion or Deduction for 2013.

Foreign Earned Income Taxable where Waiver Request Denied (*James F. and Candace H. Daly v. Comm.*, TCM 2013-147)

In 2007 and 2008, James Daly worked for L3 Communications, a Salt Lake City based defense contractor. From August 29 through December 12, 2007 (106 days), and January 25 through April 28, 2008 (94 days) Daly lived and worked on U.S. military bases in Afghanistan and Iraq. He was not permitted to leave the base where he was working and his family was not permitted to live with him. Daly also worked for L3 in Utah, California, Nevada, and Germany in 2007 and 2008. When Daly was working in Utah or not working, he stayed with his wife in their family home in Salt Lake City.

Taxpayer claims exclusion under waiver rules. On his 2007 and 2008 tax returns, Daly excluded wages of $24,888 and $22,259, respectively, that L3 paid him and attached a letter (along with Form 2555-EZ) to each year's return requesting a waiver of "foreign earned income tax 330 day requirement" and a "prorated foreign earned income excludable amount" because he was "deployed under Government orders, to a combat zones [sic]." He wrote: "I was not armed, equipped, or trained to operate in a combat environment, therefore I was not able to safely stay the required 330 days in Iraq."

Court rules tax home was in Utah, not in a foreign country. An individual will not be treated as having a tax home in a foreign country if the taxpayer's abode is within the United States (§911(d)(3)). Even though a taxpayer may have ties to a foreign country, the Courts have repeatedly held that if the taxpayer's ties to the U.S. remain strong, the taxpayer's abode remains in the U.S., especially if ties to the foreign country were transitory or limited (*James B. Harrington v. Comm*., 93 TC 297, 307 (1989)). The Court ruled that Daly's temporary location in Afghanistan and Iraq did not change the fact that his tax home in 2007 and 2008 was in the U.S. Daly did not establish a residence in a real or substantial sense in Afghanistan and/or Iraq in the years in issue.

Court says taxpayer wouldn't qualify anyway. Once the Court determined that Daly's tax home was in Utah, it did not need to determine whether Daly met the remaining requirements to exclude foreign earned income. However, the Court noted that even if it was determined that Daly's tax home was outside the U.S., he failed to meet the requirements for a waiver of the period of stay in a foreign country because he failed to show that the Secretary determined that individuals were required to leave Afghanistan and/or Iraq because of war, civil unrest, or similar adverse conditions. The Secretary publishes a list of foreign countries where war, civil unrest, or similar adverse conditions exist for purposes of section 911(d)(4)(B). No list was published for 2007, and the list that was published for 2008 did not include Iraq or Afghanistan (Rev. Proc. 2009-22, sec. 2.04).

REPORTING OF FOREIGN CURRENCY & TRANSACTIONS

Reporting Foreign Bank and Financial Accounts (FBAR) (FBAR Info; FinCEN Notice 2011-1 and 2012-1; RIN 1506-AB08; TD News Release; FinCEN Notice 2011-2 and 2012-2)

Report to Department of Treasury on FinCEN Form 114 (formerly TD F 90-22.1). Under the Bank Secrecy Act, U.S. citizens, residents, and domestic entities must file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), by June 30 if:

1. The person has a financial interest in, or signature authority (or other authority that is comparable to signature authority) over one or more accounts in a foreign country, and
2. The aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.

 Preparer note. Owners of foreign accounts are required to report their accounts, even if the accounts do not generate any taxable income.

FBAR FinCEN Form 114 Simplified for Individuals (BSA E-Filing System)

FinCEN has streamlined the process for an individual's electronic filing an FBAR (Foreign Bank and Financial Accounts) report, FinCEN 114. The new process removes the requirement for registering and creating an account on the BSA E-Filing System prior to downloading, completing, and submitting the report to the system. This process is available for individuals who are required to file an FBAR. Businesses, including CPAs, should register and create an account as an Institution on the BSA E-Filing System prior to downloading, completing and submitting FBARs on behalf of their business or clients.

Comment. Individuals can access the new process by clicking on the "File an Individual" FBAR button on the BSA E-Filing Home Page (http://bsaefiling.fincen.treas.gov/main.html).

FBAR must be filed electronically. The FBARs must be filed electronically after June 30, 2013. Previously, the FBARs could be filed electronically or by paper. No extension of time is available, but filers are allowed to amend without penalty.

FBAR Electronic Filing Requires Authorization on New FinCEN Form 114a. New Form 114a, Record of Authorization to Electronically File FBARs, must be signed by the taxpayer to allow third-party preparers to e file the FBAR form. For accounts held jointly with a spouse, each spouse must sign a Form 114a authorizing the e-file. The form is not submitted with the FBAR filing but must be retained by the third-party preparer for five years.

Schedule B, Part III Foreign Accounts and Trusts. Form 1040, Schedule B, Part III must be completed if the taxpayer (a) had over $1,500 of taxable interest or ordinary dividends, (b) had a foreign account, or (c) received a distribution from, or was a grantor of, or a transferor to, a foreign trust. Line 7a of Part III asks if the taxpayer has a signature authority over financial accounts in a foreign country of more than $10,000.

In other words, the IRS has tied together Schedule B, Part III and the requirement to file FinCEN Form 114.

CPA and Managing Director of Foreign Corporation Convicted of Failing to File Reports of Foreign Account and TD Form 90-22.1 (*U.S. v. James A. Simon*, CA-7, 11-1837, August 15, 2013; 2013-2 USTC ¶50,480)

CPA found guilty of tax fraud for not checking "Yes" on Schedule B, Part III. A jury convicted James A. Simon, a CPA and a professor of accounting who was the managing director of three foreign corporations with signature authority over the corporations' foreign bank accounts, of four counts of filing false income tax returns because he failed to check the "yes" box on his Forms 1040, Schedule B, Part III, three counts of failing to file TD Form 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), eight counts of mail fraud, and four counts of financial aid fraud. Professor Simon was required to file an FBAR for each year he had signature authority over a foreign account with a balance of $10,000 or more by June 30 of the subsequent year. The 7th Circuit Court of Appeals affirmed. In addition, because he was under civil examination by the IRS, he was not eligible for either the Voluntary Disclosure Practice or administrative relief.

Planning idea. Generally, the civil penalty for willfully failing to file an FBAR can be as high as ***the greater of*** $100,000 or 50% of the total balance of the foreign account per violation. Nonwillful violations that the IRS determines are not due to reasonable cause are subject to a $10,000 penalty per violation.

Foreign Financial Assets Disclosure—Foreign Account Tax Compliance Act (FATCA); §6038D; Form 8938; Form 8938 Instructions; IR-2011-117; Notice 2011-55; FAQs on Form 8938; IR-2012-15, T.D. 9567; Proposed Regs 26 CFR 1-301, 121647-10)

Form 8938 "Statement of Specified Foreign Financial Assets" must be attached to tax return for those with assets exceeding $50,000. The Hiring Incentives to Restore Employment (HIRE) Act contained a provision that both complements and contrasts with the FBAR filing requirement. Specifically, the HIRE Act added §6038D, ***requiring*** individual taxpayers with an aggregate balance of more than $50,000 to $150,000 for citizens not living abroad in foreign financial ***assets*** to file a statement with his or her income tax return. [2] Unlike the FBAR information, which originates under Title 31 of the U.S.C. and normally is not permitted to be verified against tax return or tax return information due to privacy and disclosure concerns, the new provision under §6038D has none of these restrictions. This change allows the IRS to use its full complement of tools to verify the information or lack of information filed.

Domestic entities and nonfilers are exempt from filing Form 8938. Until the IRS issues regulations that require a specified domestic entity to file Form 8938, only individuals must file Form 8938 (see Instructions for Form 8938). In addition, Form 8938 is not required of individuals who do not have an income tax return filing requirement.

What's required in the disclosure? Form 8938 disclosure statement requires the reporting of the ***maximum value of the foreign assets*** during the taxable year. The disclosure statement should also provide the following information in the case of a:

1. ***Financial account***—the name and address of the foreign financial institution in which such account is maintained and the number of such account.
2. ***Stock or security***—the name and address of the foreign issuer and such information as is necessary to identify the class or issue of which such stock or security is part.
3. ***Contract, interest, or other instrument***—such information as is necessary to identify such contract, interest, or other instrument and the names and addresses of all foreign issuers and counterparties with respect to such contract, interest, or other instrument.

Foreign currency conversion. If the foreign financial asset is reported in a foreign currency, the maximum value of the asset must be determined in the foreign currency and then converted to U.S. dollars. In most cases, the U.S. Treasury Department's Financial Management Service foreign currency exchange rate for purchasing U.S. dollars must be used. This rate can be found at http://www.fms.treas.gov/intn.html

Foreign Financial Assets Must Exceed a Filing Threshold before Form 8938 is Required (Form 8938 Instructions)

As can be seen by the following chart, the IRS requires individual taxpayers with foreign financial assets in excess of a filing threshold to file a statement with his or her income tax return. For example, a single taxpayer not living abroad must file Form 8938 if the total value of his or her foreign financial assets exceed $50,000 on the last day of the year OR $75,000 at any time during the year. These amounts double for those who are married filing jointly.

	If Total Value of Foreign Financial Assets Exceed		
Not Living Abroad	**On Last Day of the Year**		**At Any Time During the Year**

[2] $200,000 to $600,000 for taxpayers living abroad.

Single and MFS	$50,000	OR	$75,000
Married Filing Joint	$100,000	OR	$150,000
Living Abroad			
Single and MFS	$200,000	OR	$300,000
Married Filing Joint	$400,000	OR	$600,000

Offshore Tax Havens Cost the U.S. Treasury $150 Billion a Year (Picking up the Tab 2013)

A report by the U.S. Public Interest Research Group estimates that tax havens used by corporations and wealthy individuals cost the U.S. Treasury $150 billion each year in lost revenue. The report claims that the average small business pays an additional $3,067 each year to cover the taxes avoided by large corporations. In 2008, 83 of the 100 largest publically traded U.S. companies had revenue in tax haven countries. The report used Pfizer, Microsoft, General Electric, and Citigroup as examples.

> **Caterpillar Tax Move**. Caterpillar, Inc. avoided paying $2.4 billion in U.S. taxes from 2000 to 2012 by moving profits from sales of replacement parts through its Swiss unit.

Offshore Voluntary Disclosure Program (IR-2012-64; IR-2012-5, IRS FAQs; 2012 Offshore Voluntary Disclosure Program Submission Requirements; Foreign Account and Asset Statement; Offshore Voluntary Disclosure Letter and Attachment)

Voluntary Disclosures of Offshore Accounts Reach 43,000. Voluntary disclosures of offshore accounts held by U.S. account holders have reached 43,000 according to the Department of Justice. Criminal charges have been brought against 71 account holders with 63 having pled guilty and five having been convicted. The DOJ has ongoing investigations of 14 Swiss banks and is looking into banks in other countries, including Liechtenstein, Luxembourg, Israel, India, and the Caribbean area.

OVDP is to encourage taxpayers to volunteer to resolve tax problems. The purpose for the voluntary disclosure practice is to provide a way for taxpayers who did not report taxable income in the past to come forward voluntarily and resolve their tax matters. The objective of the Offshore Voluntary Disclosure Program (OVDP) is to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws.

If the taxpayer reported, and paid tax on, all taxable income but did not file FBARs, the taxpayer should not use the voluntary disclosure process. For taxpayers who reported and paid tax on all their taxable income for prior years but did not file FBARs, they should file the delinquent FBARs according to the FBAR instructions and include a statement explaining why the FBARs are filed late. The IRS will not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities and the taxpayer has not previously been contacted regarding an income tax examination or a request for delinquent returns (OVDP Q&A # 17).

Requirements of the Offshore Voluntary Disclosure Program. Under the terms of the Offshore Voluntary Disclosure Program, for the tax years covered by the voluntary disclosure taxpayers must:

Provide copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns;
File original or amended FBAR Form FinCEN Form 114;
Cooperate in the voluntary disclosure process including providing information about offshore financial institutions, offshore service providers, and other facilitators, if requested;
Pay the 20% accuracy-related §6662(a) penalties on the full amount of the offshore-related underpayments of tax for all years, the §6651(a)(1) failure to file penalties, if applicable, and/or the §6651(a)(2) failure to pay penalties, if applicable;
Pay, in lieu of all other penalties, 27.5% (or in limited cases 12.5% or 5%) of the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the period covered by the voluntary disclosure; and
Execute a Closing Agreement on Final Determination Covering Specific Matters, Form 906.

Other FBAR/OVDP Provisions (Offshore Voluntary Disclosure Program FAQs)

For calendar year taxpayers the voluntary disclosure period is the most recent eight tax years for which the due date has already passed. The eight-year period does not include current years for which there has not yet been noncompliance. For example, for taxpayers who submit a voluntary disclosure prior to April 15, 2012 (or other 2011 due date under extension), the disclosure must include each of the years 2003 through 2010 in which they have undisclosed foreign accounts and/or undisclosed foreign entities (OVDP Q&A # 9).
IRS examiners do not have any discretion to settle offshore voluntary disclosure cases (OVDP Q&A # 50).
Tax preparers with clients who decline making full disclosure may not prepare the client's income tax return for that year without being in violation of Circular 230 (OVDP FAQ # 47).
A "quiet disclosure" (filing amended returns and paying any related tax and interest for previously unreported offshore income without otherwise notifying the IRS) must still come forward under the OVDP to make timely, accurate, and complete disclosures. Those taxpayers making "quiet disclosures" should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years (OVDP FAQ # 15).

IRS Example on How the Offshore Penalty Framework Works (Offshore Voluntary Disclosure Program FAQ # 8)

The values of foreign accounts and other foreign assets are aggregated for each year, and the penalty is calculated at 27.5% of the highest year's aggregate value during the period covered by the voluntary disclosure. If the taxpayer has multiple accounts or assets where the highest value of some accounts or assets is in different years, the values of accounts and other assets are aggregated for each year and a single penalty is calculated at 27.5% of the highest year's aggregate value.

> **Example.** Assume Lily deposits $1 million in a Hong Kong bank account in 2003. The account earns $50,000 of interest income each year. In 2010, the balance in the account is $1.4 million. Lily did not file an FBAR or report the interest income on her tax returns.
>
> **Preparer note.** The IRS example does not provide for compounded interest and assumes the taxpayer is in the 35% tax bracket, does not have an investment in a Passive Foreign Investment Company (PFIC), files a return but does not include the foreign account or the interest income on the return, and the maximum applicable penalties are imposed.

$553,000 plus interest with voluntary disclosure, per FAQ #8. If the taxpayer in the above example comes forward and her voluntary disclosure is accepted by the IRS, she would pay $553,000 plus interest.[3] This includes:

Tax of $140,000 (8 years at $17,500) plus interest,

An accuracy-related penalty of $28,000 (i.e., $140,000 × 20%), and

An additional penalty, in lieu of the FBAR and other potential penalties that may apply, of $385,000 (i.e., $1,400,000 x 27.5%).

$4,378,000 plus penalty without voluntary disclosure. If the taxpayer didn't come forward, when the IRS discovered her offshore activities, she would face up to $4,378,000 in tax, accuracy-related penalty, and FBAR penalty.[4] The taxpayer would also be liable for interest and possibly additional penalties, and an examination could lead to criminal prosecution. The civil liabilities outside the Offshore Voluntary Disclosure Program potentially include:

The tax, accuracy-related penalties, and, if applicable, the failure to file and failure to pay penalties, plus interest, as described above,

50% FBAR penalties totaling up to $3,825,000 for willful failures to file complete and correct FBARs (2005 - $575,000, 2006 - $600,000, 2007 - $625,000, 2008 - $650,000, and 2009 - $675,000, and 2010 - $700,000) [Note: 2013 would be 2004-2012],

The potential of having the fraud penalty (75%) apply, and

The potential of substantial additional information return penalties if the foreign account or assets is held through a foreign entity such as a trust or corporation and required information returns were not filed.

Reporting by Foreign Financial Institutions (Notice 2013-43)

FATCA also requires foreign financial institutions (FFIs) to report directly to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. To comply properly with these new reporting requirements, an FFI must enter into a special agreement with the IRS by June 30, 2013. Under this agreement a "participating" FFI will be obligated to:

1. undertake certain identification and due diligence procedures with respect to its account holders;
2. report annually to the IRS on its account holders who are U.S. persons or foreign entities with substantial U.S. ownership; and
3. ***withhold and pay over to the IRS 30% of any payments of U.S. source income,*** as well as gross proceeds from the sale of securities that generate U.S. source income, made to (a) nonparticipating FFIs, (b) individual account holders failing to provide sufficient information to determine whether or not they are U.S. persons, or (c) foreign entity account holders failing to provide sufficient information about the identity of their substantial U.S. owners.

"Last Substantial Package" of Regulations to Implement FATCA Released (TDNR JL-2296, Fact Sheet, T.D. 9657, T.D. 9658; REG-130967-13; REG-134361-12); Treasury's FATCA Resource Center)

[3] The addition in the FAQ was incorrect. $553,000 is the correct number.

[4] The addition in the FAQ was incorrect. $553,000 plus $3,825,000 equals the correct number.

Final, temporary, and proposed regulations to implement the Foreign Account Tax Compliance Act (FATCA) take effect on July 1, 2014. T.D. 9657 amends and clarifies final FATCA regulations (see §§1471-1474). T.D. 9658 contain rules requiring reporting and withholding (See §3406). These two sets of regulations are expected to be the "last substantial package of rules" and are the "last big step" to implementing FATCA. There are no government plans to delay the July 1, 2014, effective date. Specifically, Chapter 61 and §3406 address the reporting and backup withholding requirements regarding payments to U.S. persons, while Chapter 3 imposes withholding and reporting requirements regarding payments to non-U.S. persons.

22 countries have signed a Foreign Financial Institution agreement—more expected shortly. To discover international tax evasion, FATCA seeks to obtain information on accounts held by U.S. taxpayers in other countries. It generally requires U.S. financial institutions to withhold a portion of certain payments made to certain foreign financial institutions (FFIs) that do not agree to identify and report information on U.S. account holders. The United States has signed agreements with 22 countries, and many more have either reached agreements in substance that are awaiting signature, or are well along in the process.

Final regulation amendments. Regulations contain over 50 discrete amendments and clarifications to the FATCA regulations issued in January 2013 to provide clarifications and to take into account certain stakeholder suggestions regarding ways to further reduce burdens consistent with the compliance objectives of the statute. Key amendments and clarifications include those relating to:

1. the accommodation of direct reporting to the IRS, rather than to withholding agents, by certain entities regarding their substantial U.S. owners;
2. the treatment of certain special-purpose debt securitization vehicles;
3. the treatment of disregarded entities as branches of foreign financial institutions;
4. the definition of an expanded affiliated group; and
5. transitional rules for collateral arrangements prior to 2017.

IRS Posts Chart Comparing FATCA - Form 8938 and FBAR, updated Feb. 10, 2014

Clients may need to file Form 8938 and FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). The filing of Form 8938 does not relieve the taxpayer of the separate requirement to file the FBAR if otherwise required to do so, and vice-versa. Depending on the taxpayer's situation, Form 8938, or FinCEN Form 114, or both forms may be required. Some foreign accounts may be required to be reported on both forms.

FBAR and FATCA can have different reporting requirements. Differences exist between the FBAR requirements and FATCA (§6038D) requirements. Individual taxpayers in similar circumstances could have different reporting outcomes.

Comparison Chart FATCA vs. FBAR		
	Form 8938, Statement of Specified Foreign Financial Assets **(FATCA)**	**FinCEN Form 114,** Report of Foreign Bank and Financial Accounts **(FBAR)**

Comparison Chart FATCA vs. FBAR		
	Form 8938, Statement of Specified Foreign Financial Assets **(FATCA)**	**FinCEN Form 114,** Report of Foreign Bank and Financial Accounts **(FBAR)**
Who must file?	Specified individuals, which include U.S. citizens, resident aliens, and certain nonresident aliens that have an interest in specified foreign financial assets and meet the reporting threshold.	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold.
Does the United States include U.S. territories?	No.	Yes, resident aliens of U.S. territories and U.S. territory entities are subject to FBAR.
Reporting Threshold (Total Value of Assets)	$50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad).	$10,000 at any time during the calendar year.
When do you have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return.	Financial interest: the taxpayer is the owner of record or holder of legal title; the owner of record or holder of legal title is the taxpayer's agent or representative; the taxpayer has a sufficient interest in the entity that is the owner of record or holder of legal title. Signature authority: the taxpayer has authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account.

Comparison Chart FATCA vs. FBAR		
	Form 8938, Statement of Specified Foreign Financial Assets **(FATCA)**	**FinCEN Form 114,** Report of Foreign Bank and Financial Accounts **(FBAR)**
What is reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign nonaccount investment assets.	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country.
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported. Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars. Rates can be found at http://www.fms.treas.gov/intn.html	Use periodic account statements to determine the maximum value in the currency of the account. Convert to U.S. dollars using the end of the calendar year exchange rate and report in U.S. dollars. Find rates at http://www.fms.treas.gov/intn.html
When due?	By due date, including extension, if any, for income tax return.	June 30th (no extensions of time granted).
Where to file?	File with income tax return pursuant to instructions for filing the return.	May only be filed electronically using the BSA E-Filing System.
Penalties	Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of nonfiling after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply.	If nonwillful, up to $10,000; if willful, up to the greater of $100,000 or 50% of account balances; criminal penalties may also apply.

Types of Foreign Assets and Whether They are Reportable		
	Form 8938, Statement of Specified Foreign Financial Assets **(FATCA)**	**FinCEN Form 114,** Report of Foreign Bank and Financial Accounts **(FBAR)**

Financial (deposit and custodial) accounts held at foreign financial institutions	Yes	Yes
Financial account held at a foreign branch of a U.S. financial institution	No	Yes
Financial account held at a U.S. branch of a foreign financial institution	No	No
Foreign financial account for which you have signature authority	No, unless you otherwise have an interest in the account as described above.	Yes, subject to exceptions.
Foreign stock or securities held in a financial account at a foreign financial institution	The account itself is subject to reporting, but the contents of the account do not have to be separately reported.	The account itself is subject to reporting, but the contents of the account do not have to be separately reported.
Foreign stock or securities not held in a financial account	Yes	No
Foreign partnership interests	Yes	No
Indirect interests in foreign financial assets through an entity	No	Yes, if sufficient ownership or beneficial interest (i.e., a greater than 50% interest) in the entity.
Foreign mutual funds	Yes	Yes
Domestic mutual fund investing in foreign stocks and securities	No	No
Foreign accounts and foreign nonaccount investment assets held by foreign or domestic grantor trust for which you are the grantor	Yes, as to both foreign accounts and foreign nonaccount investment assets.	Yes, as to foreign accounts.
Foreign-issued life insurance or annuity contract with a cash-value	Yes	Yes
Foreign hedge funds and foreign private equity funds	Yes	No
Foreign real estate held directly	No	No

Types of Foreign Assets and Whether They are Reportable		
	Form 8938, Statement of Specified Foreign Financial Assets **(FATCA)**	**FinCEN Form 114,** Report of Foreign Bank and Financial Accounts **(FBAR)**
Financial (deposit and custodial) accounts held at foreign financial institutions	Yes	Yes
Foreign real estate held through a foreign entity	No, but the foreign entity itself is a specified foreign financial asset and its maximum value includes the value of the real estate.	No
Foreign currency held directly	No	No
Precious metals held directly	No	No
Personal property, held directly, such as art, antiques, jewelry, cars and other collectibles	No	No
Social Security-type program benefits provided by a foreign government	No	No

Telephone Numbers for FBAR and FATCA Help. The IRS FBAR and FFA Helpline connects practitioners and filers, both domestic and abroad, with a team of specially trained technicians, examiners and specialists to answer technical Title 31 questions. Help with FBAR and FFA reporting can be had at the IRS special help line at 866-270-0733 for callers within the U.S. and 313-234-6146 for callers outside the U.S.

Duplicate Reporting is Not Required

Other foreign reporting. Taxpayers do not have to report a specified foreign financial asset on Form 8938 if it is reported on one or more of the following forms that have been timely filed for the same tax year:

- Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
- Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations
- Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships
- Form 8891, U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans

Foreign Trust Reporting Form 3520 and/or Form 3520-A

Although there are legitimate reasons why a U.S. person might create a foreign trust or have transactions with a foreign trust, he or she can have tax consequences and result in filing responsibilities as well. Regardless of the motivation, failure to meet these reporting and filing requirements can result in very significant penalties.

General rules. In general, the reporting rules apply to a U.S. person who:

- Creates a foreign trust
- Transfers any money or property to a foreign trust
- Receives a distribution from a foreign trust
- Is treated as the U.S. owner of a foreign trust

Mexican Land Trust (MLT) is Not a Trust (Rev. Rul. 2013-14; LTR 201245003)

The Mexican Federal Constitution prohibits non-Mexican persons from directly holding title to residential real property in certain areas of Mexico ("restricted zones"). Non-Mexican persons may, however, hold residential real property located in the restricted zones through a "fideicomiso" (Mexican Land Trust) agreement with a Mexican bank after obtaining a permit from the Mexican Ministry of Foreign Affairs.

> **Preparer note**. Property owned by a U.S. citizen in Mexico is often titled to a trust.

Non-Mexican person is the owner, not the bank. Typically in situations where a Mexican Land Trust is required, the deed to the property is recorded in the name of bank, but the non-Mexican person(s) directly negotiates the purchase of the property and has no actual interaction with the bank. The owners, not the bank, maintain the unrestricted right to sell or mortgage the property, and they generally have the exclusive right to possess the property and make any desired modifications. If the property is leased, the owners, not the bank, typically receive any rental income and pay all related expenses. The Mexican bank collects an annual fee and disclaims all responsibility for the property, including obtaining clear title and has no duty to defend or maintain the property. The bank's only duties under an MLT agreement is to hold the legal title to real estate and transfer title at the direction of its owner. Accordingly, the non-Mexican person, not the bank, is treated as the owner of the real estate.

IRS example (LTR 201245003). A corporation owned 100% by a husband and wife purchased a condominium in Mexico through a Mexican Land Trust (fideicomiso) agreement with a Mexican bank. While the deed to the condominium was recorded in the name of bank, the husband and wife negotiated directly with the condominium seller regarding the terms of the sale, paid the seller directly, and had no interactions with the Mexican bank. The couple's corporation maintained the unrestricted right to sell or mortgage the condominium without the Bank's permission. Furthermore, the couple, through their corporation, had the exclusive right to possess the condominium and to make any desired modifications. If the condominium was leased, the corporation directly received the rental income and paid taxes on the income. The Mexican bank collected an annual fee and disclaimed all responsibility for the condominium, including obtaining clear title and had no duty to defend or maintain the condominium.

Form 3520 or 3520A not required. The IRS concluded that the sole purpose of the Mexican Land Trust was to satisfy the Mexican law by vesting legal title to the property in the name of the trustee (the bank).

The bank's sole responsibility for the property was to hold and transfer title if so directed by the taxpayers. The couple retained sole authority to manage and control the property, the direct right to collect any rents or proceeds generated by the property, and the direct obligation to pay all taxes and liabilities related to the property. The IRS ruled that the husband and wife, not the Trust, were the owners of the condominium for federal income tax purposes.

See also: Rev. Rul. 92-105 where a trust, as defined under §301.7701-4(a), was not established when an Illinois Land Trust trustee's sole responsibility was to hold and transfer title to real property at the direction of the taxpayer. The trustee was deemed merely to be an agent for holding and transferring title to real property, and the taxpayer retained direct ownership for Federal income tax purposes.

OTHER GROSS INCOME ITEMS

MINISTER RENTAL ALLOWANCE - §107

Exclusion of a Parsonage Allowance Requires Advanced Planning (*Ricky Williams, pro se v. Comm.*, TCS 2013-60); also see *Donald L. Rogers v. Comm.*, TCM 2013-177)

As a prerequisite for excluding a parsonage allowance, the minister must establish that there is a designation of the rental allowance pursuant to official church action before payment. Gross income of a minister does not include "the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities" (§107(2)). But, in order for a minister to be eligible for this exclusion, the following requirements must be met:

1. the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel;
2. ***before the payment of this rental allowance***, the employing church or other qualified organization must designate the rental allowance pursuant to official action, which may be evidenced in an employment contract or by any other appropriate instrument; and
3. the designation must be sufficient in that it clearly identifies the portion of the minister's salary that is the rental allowance (§1.107-1(a) and (b))

Written agreement required. The original employment agreement between Pastor Williams and the St. John Missionary Baptist Church did not designate a parsonage allowance. At trial Pastor Williams provided a second employment agreement which was executed in 2012. A 2012 document could not retroactively designate an amount as a parsonage allowance for a 2007 payment.

> **Preparer idea**. For more info on parsonage allowances see the annual minister's tax guide made available at GuideStone.org.

District Court Rules Parsonage Allowance Unconstitutional; DOJ Appeals (Freedom From Religion Foundation, Annie Laurie Gaylor and Dan Barker v. Jacob Lew, Acting Secretary of the Treasury Department and Daniel Werfel, Acting Commissioner of the International Revenue Service, Nov. 22, 2013)

U.S. District Court Judge Barbara Crabb ruled in Nov. 2013 that the parsonage allowance violates the separation of church and state and the constitutional guarantee of equal protection, saying the exemption "provides a benefit to religious persons and no one else, even though doing so is not necessary to alleviate a special burden on religious exercise."

DOJ appeals. Although the decision holds §107(c) to be unconstitutional, the ruling delays the effect until appeals are exhausted. Jan. 24, 2014, the Department of Justice announced that it would appeal the decision to the 7th Circuit U.S. Court of Appeals in Chicago.

> **Note**. The ruling affects about 44,000 with an annual tax cost of approximately $700 million. The ruling did not address clergy living in parsonages or rectories provided by their congregations.

FOSTER CARE PAYMENTS (§131)

Foster Care Payments Generally Excludable (§131)

Foster care providers may generally exclude from income qualified foster care payments. To qualify for exclusion, payments must be made under a foster care program of a state or political subdivision and:

1. Be paid to a foster care provider who cares for a "qualified foster individual" in the provider's home; or,
2. Qualify as a "difficulty of care payment."

"Qualified foster individual" is any individual living in a foster family home in which the individual was placed by an agency of a state or political subdivision or by a qualified foster care placement agency.

"Qualified foster care placement agency" is a placement agency that is licensed or certified for the foster care program of a state or political subdivision of a state.

"Difficulty of care payment" is compensation to a foster care provider for the additional care required because the qualified foster individual has a physical, mental, or emotional handicap. The provider must provide the care in the provider's foster family home, a state must determine the compensation is needed, and the payor must designate the compensation for this purpose.

> **Preparer note.** In the case of any foster home, difficulty of care payments are not excludable to the extent that the payments are for more than 10 qualified foster individuals who have not attained age 19 or 5 qualified foster individuals who have attained age 19.

Historically IRS says payments made to related care provider are taxable. The IRS has historically taken the position that a biological parent of a disabled child may not exclude payments under §131 because care by a biological parent is not foster care (PMTA 2010-007). When litigating this issue, the IRS has argued that a parent may not exclude payments received for in-home supportive services to a disabled adult child, and that an adult child may not exclude payments received for personal care services to a parent (See *Bannon v. Comm.*, 99 TC 59 (1992) and *Al C. Alexander v. Comm.*, TCS 2011-48).

Mother Provides Care to Keep Son from Institutionalization (*Robert and Elaina Ray v. U.S.*, USDC SD Ohio East. Div., 2:12-cv-677, Jan. 6, 2014)

Elaina Ray argued that $56,642 she received in 2007 from the Ohio Dept. of Developmental Disabilities to provide personal care for her adult son, Tony, was excludable under §131. Tony was severely handicapped and, since turning 18, his care was managed by the Franklin County Board of Developmental Disabilities (FCBDD). Because Tony's needs were severe and many, the FCBDD required that anyone providing him care had to be a certified home and community based living provider. Elaina obtained such certification and was hired by FCBDD to be Tony's care giver in her home. Elaina also served as Tony's legal guardian once he turned.

IRS says "foster" care cannot be provided to own child. The IRS agreed that Elaina received payments from the State of Ohio and that Tony was placed in her home by an agency of a political subdivision of the State of Ohio. The IRS, however, did not agree that Elaina provided foster care, arguing the meaning of "foster" and "foster care" concerns the placement of a minor into the care of someone ***who is not the minor's parent by blood or legal adoption***. The IRS argument was based on the dictionary definition of "foster care," which states the definition includes "affording, receiving, or sharing nourishment, upbringing, or parental care ***though not related by blood or legal ties***."

Court says relationship is not the problem, but guardianship is. The Rays argued that key element in the concept of "foster care" was the assumption of a duty to provide care to an individual in need where such a duty is not otherwise imposed by law. The Rays agreed that a parent by blood or adoption cannot be a foster parent to a minor child because a legal duty to provide care is already imposed by law, but that this legal obligation ceases when the child reaches age 18. Thus, the Rays argued that they had no duty to care for Tony once he turned age 18 and that their voluntary assumption of care for him satisfied the definition of foster care. The Court concluded that what characterizes a foster care relationship is the provision of care in one's home to an individual in the absence of an existing legal duty to provide such care to that individual and ruled that the guardianship counted as an existing legal duty. The income Elaina received was taxable.

> **Preparer note.** In its opinion, the Court made it clear that it would have sided the Rays if Elaina was not Tony's guardian. It seems this should be considered when setting up guardianships

Also see:

Carolyn Harper, TCS 2011-46, payments for care of disabled son in Oregon were taxable.
Info Letter 2012-0009 where payments for care of disabled son in West Virginia were taxable.

IRS Reverses Its Position for Foster Care Payments Made to Family Members (Notice 2014-7)

Foster care payments and state Medicaid programs. States may obtain a Medicaid waiver which allows them to include in the state's Medicaid program the cost of home or community-based services provided to individuals who otherwise would require care in a hospital or nursing facility. Home or community-based services include personal care (e.g., assistance with eating, bathing, dressing, money management, etc.), habilitation (e.g., help with socialization, adaptive skills, etc.), and other services that are necessary to avoid institutionalization. Medicaid waiver programs generally do not compensate family members who provide personal care services to an eligible individual if the family member is legally responsible for the individual (e.g., a minor child). However, some states compensate family members, as well as unrelated care providers, for care services provided as a part of an eligible individual's plan of care.

Exclusion under §131 applies to unrelated and related care providers. Beginning Jan. 3, 2014, the IRS will treat qualified Medicaid waiver payments as excludable difficulty of care payments under §131(c). This treatment applies whether the care provider is related or unrelated to the eligible individual. The IRS will no longer assert the position set forth in PMTA 2010-007 (and in the *Alexander, Bannon,* or *Harper* court cases) that a care provider of a biological relative receiving qualified Medicaid waiver payments does not qualify as a foster care provider under §131. For purposes of this notice, qualified Medicaid waiver payments are payments made by a state or political subdivision thereof, or an entity that is a certified Medicaid provider, under a Medicaid waiver program to an individual care provider for nonmedical support services provided under a plan of care to an eligible individual (whether related or unrelated) living in the individual care provider's home. All other provisions of §131 continue to apply.

> **Preparer note.** As the effective date of this Notice is Jan. 3, 2014, it doesn't seem to provide any relief in previously litigated cases as discussed above. Sometimes life just isn't fair!

ANNUITY PAYMENT

Termination of Life Insurance Policy Resulted in Taxable Distribution *(Boyd J. and Janice C. Black v. Comm., pro se,* TCM 2014-27)

Insurance loan payoff is constructive distribution. An amount received in connection with a life insurance contract which is not received as an annuity generally constitutes gross income to the extent that the amount received exceeds the investment in the insurance contract (§72(e)(1)(A), (5)(A), (C)).

Capitalized interest must be added to loan principal. Boyd and Janice Black borrowed against a life insurance policy but failed to repay the loans. The policy was terminated, and the loans were satisfied by policy proceeds and extinguished. The IRS contended that the amount realized upon termination of the policy included both loan principal and capitalized interest. The Blacks contended that the amount realized included only loan principal. The court held that the capitalized interest that accrued on Black's loans against his life insurance policy were includible in determining the gross distribution and the taxable amount arising from the termination of the policy. The taxable amount of the distribution was the difference between the combined balance of the loans at the time the policy was terminated, and the taxpayer's investment in the contract.

Also see:

> *Bruce A. Brown and Carol Anfinson Brown v. Comm.*, 11-2508 (CA-7),(Sep. 11, 2012), cash value of a terminated whole life insurance policy that exceeded amount paid for the policy includible in taxpayer's income. The income was used to pay a debt to the insurance company. It was irrelevant that the debt paid was personal, therefore not deductible, rather than a business.

> *Ronald Webster Moore, pro se, v. Comm.*, (TCS 2012-83), Ronald Moore bought a $20,000 life insurance policy in 1975. The policy required a monthly payment of $26. Mr. Moore made payments for 18 months ($472). He stopped making payments in 1977 and believed that the policy lapsed shortly thereafter. Because he signed an "automatic premium loan" provision in the policy, Nationwide Insurance kept the policy in force until 2008 by using the policy value to secure a premium loan. In 2008, when the policy value could no longer support the additional loan amounts, the policy lapsed. Nationwide issued a Form 1099R showing a taxable distribution of $17,941 (the premium loan balance less investment in the policy). For Federal income tax

purposes, loans against a life insurance contract's cash value are treated as true loans from the insurance company to the policyholder with the policy serving as collateral. The IRS argued that the taxpayer received value for the loan (30 years of life insurance), and thus when the loan was cancelled, Mr. Moore should have had taxable income. The Court however, for "several unexplained discrepancies in the record," ruled that the policy terminated in a year earlier than 2008 and thus no taxable income resulted in 2008.

PUNITIVE DAMAGE AWARD

Punitive Damage Award was Taxable including Attorney Fees Withheld (*Raphael Dang-Quang Cung, pro se. v. Comm.*, TCM 2013-81)

Raphael Cung saw an online advertisement at www.autotrader.com for a "Certified Pre-Owned" 2004 BMW 645Ci convertible. The advertisement listed the price at $36,864. When Mr. Cung called the dealer, BMW of Monterey, he was told that the $36,864 price was a mistake and that he could purchase the car for $56,000.

Taxpayer sued the car dealer for error in ad. Mr. Cung demanded that the dealership honor the advertised price, and it refused. Mr. Cung filed a lawsuit alleging various violations of California law and breach of contract. He sought injunctive relief, including a court order that the dealer sell him the car for the advertised price, damages of no less than $20,000, punitive damages, attorney's fees and costs, and other legal or equitable relief.

Taxpayer settled for $17,000. Mr. Cung settled the suit for $17,000 in July 2008. The settlement check was payable to Mr. Cung's attorney who, per their agreement, kept $2,000 as a fee and wrote a check to him for $15,000. Mr. Cung's attorney issued him a Form 1099-MISC for 2008 listing nonemployee compensation of $15,000. Mr. Cung did not report the amount on his income tax return.

Punitive damage award is taxable. Gross income is defined as "all income from whatever source derived"(§61(a)). Mr. Cung failed to carry his burden of showing that the proceeds represent what he claims they represent, lost value. The Court ruled that the settlement proceeds are taxable as ordinary income.

Attorney fees withheld from the settlement are part of the taxable gross. The Supreme Court has stated that "as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee" (*Comm. v. Banks*, 543 U.S. 426, 430 (2005)). The settlement consisted of $17,000, of which Mr. Cung's attorney retained $2,000. Therefore, the $2,000 is taxable income of Mr. Cung. The attorney fees are deductible as an itemized deduction.

CANCELLATION OF DEBT

Cancelled Credit Card Debt Creates COD Income (§61(a)(12)/§108)

Taxpayers Unable to Prove Insolvency - Discharge of Credit Card Debt Taxable *(Najeem B. and Olubunmi A. Adeyemo v. Comm.*, TCM 2014-1)

The Adeyemos received a 1099-C reporting the discharge of $32,926 of credit card debt. Using the insolvency exemption, the Adeyemos excluded the cancellation of debt (COD) income from taxation pursuant to §108(a)(1)(B)).

Insolvency requires proof of debt and proof of FMV of assets. Taxpayers must prove that their total liabilities exceed the fair market value of their assets immediately before the debt discharge to utilize the insolvency exclusion (*Merkel v. Comm*., 109 T.C. 463, 476 (1997), aff'd, [99-2 USTC ¶50,848] 192 F.3d 844 (9th Cir. 1999)). The Adeyemos provided no evidence of their outstanding assets or liabilities at the time the credit-card debt was discharged and the Court ruled that they were not insolvent.

> **Preparer note.** The IRS is targeting and challenging taxpayer insolvency claims. Tax professionals should consider including the insolvency worksheet included in Pub. 4681 in their supporting documents for such taxpayers.

> **Preparer note.** The insolvency exclusion is reported on Form 982.

PERSONAL INJURY AWARD

Compensation for Injury or Sickness & Punitive Damages Taxable (§104)

Introduction. Generally, compensation for personal injuries and sickness is excluded from gross income, specifically:

1. Amounts received under workers' compensation (§104(a)(1));
2. The amount of damages received (other than punitive damages) on account of personal physical injuries or physical sickness (§104(a)(2)). The exception generally excludes only physical injuries but not emotional distress (because of age, race, gender, or disability), libel, slander, and other nonphysical wrongs;
3. Amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (§104(a)(3));
4. Amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces, Foreign Service or Public Health Service (§104(a)(4); and
5. Amounts received as disability income attributable to injuries incurred as a direct result of a terrorist or military action (as defined by §692(c)(2) (§104(a)(5)).

> **Preparer note.** More information is available from the IRS' Lawsuits, Awards and Settlements Audit Technique Guide (ATG).

Payers of Nontaxable Physical Injury Awards are not Required to File Form 1099 (PLR 201311006)

An accident resulted in victims either (i) suffering a cut, scrape, bruise, or other visible physical injury, or suffering smoke inhalation during the incident, or both (ii) being a close relative (spouse, parent, child, or sibling) of a person who was killed in the incident, or (iii) being the estate of a person who was killed in the incident. The responsible parties have or will pay victims claims for wrongful death and physical injury.

Award for physical injury is tax free. In general, gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal physical injuries or physical sickness (§104(a)(2)). Damages (other than punitive damages) received on account of a claim of wrongful death are excludable from taxable income. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to physical injury or physical sickness. Since in this PLR ,each of the victims suffered a personal physical injury or physical sickness as a result of the incident, the damages that each received was excludable from income.

Form 1099 not required for nontaxable distribution. Persons engaged in a trade or business are required to (1) file an information return for each calendar year in which the person makes in the course of its trade or business payments to another person of fixed and determinable income aggregating $600 or more, and (2) furnish a copy of the information return to that person (§6041(a) and (d); §1.6041-1(a)(1) and (a)(2)). Because in this PLR the damages were excluded from gross income, they were not income under §6041. Thus, taxpayer was not required to file information returns with respect to distributions of damages to victims.

Compensation for Psychological Harm Due to a Physical Injury is Excludable (PLR 201328022)

Awards for emotional distress are not excludable under §104 since they are not for physical injury. But an award that arose from a physical injury is excludable even though it provides for compensation for psychological damages due to the injury. Thus, the IRS ruled that the award to compensate the taxpayer for lost wages, medical expenses, and other pecuniary losses incurred or expected to be incurred from psychological harms that originated in the personal physical injuries is excludable.

Legal Settlement Received to Compensate for Headaches Caused by Retaliatory Eviction Taxable (*Aster Tirfe, pro se. v. Comm.*, TCS 2013-42)

Aster Tirfe lived in an apartment in Arcadia, California with her two children and a dog. In July 2006, her landlord began eviction proceedings against her, and, as a result, she moved to a new apartment. In January 2007, Tirfe sued her landlord asserting loss of important housing opportunities, deprivation of the full use and enjoyment of her tenancy, severe emotional distress and physical injury, humiliation and mental anguish, including bodily injury such as stomach aches; headaches; sleep loss; feelings of depression, discouragement, anger, and nervousness. The jury awarded Tirfe damages of $17,454 and noneconomic loss damages of $2,700 (jury award).

Emotional distress (including related upset stomachs or headaches) is not included in the definition of "physical injury or physical sickness." The Court determined that the amount awarded to Tirfe was intended to compensate Tirfe for the additional rental expenses incurred as a result of her landlord's retaliatory eviction, not from personal physical injuries or physical sickness, and ruled that such damages on account of financial or economic losses are not excludable under §104(a)(2).

Workers' Compensation Payments

Introduction. Compensation for personal injuries and sickness is excludable from gross income if received under a workers' compensation act (other than for medical expenses previously deducted and the interest portion of a worker's compensation award) (§104(a)(1)). But specific provisions of the applicable state statutes determine if the exclusion applies. §104(a)(1) does not apply to retirement benefits to the extent determined by reference to the employee's age, length of service, or prior contributions, even though retirement is occasioned by occupational injury or sickness. If an employee compensation plan combines disability and retirement elements (common among plans for public employees), the exclusion applies only to the extent the benefits are attributable to personal injury or sickness incurred in the course of employment, without reference to the employee's age, length of service, or prior contributions. Additionally, it does not apply to compensation for nonoccupational injuries or sickness (§1.104-1(b)).

> **Preparer note**. The primary issues in most of this year's cases and rulings deal with determining if the disability payments (1) are made under applicable state workers' compensation statutes, and (2) are made without reference to the employee's age, length of service, or prior contributions.

Disability retirement not always tax free. In order to exclude disability retirement under §104(a)(1), §104(a)(2), or §105(c), the benefits must:

1. Be received under a worker's compensation plan, not through a private collectively bargained agreement (§104(a)(1)),
2. Be received through a lawsuit or a settlement based on a tort-like claim (not the result of an employment related benefit) (§104(a)(2)), and
3. Be calculated based on the nature of the injury, not on the number of years employed (§105(c)(2)).

Lump Sum Death Benefit Paid to Beneficiaries of Public Employees Who Die in Line of Duty Excluded from Gross Income (LTR 201318001)

Taxpayer, a political subdivision, adopted a plan that provides for payment of benefits to qualifying beneficiaries of certain public employees who die in the line of duty. The plan was funded with Taxpayer and public contributions to the plan. Payments under the plan are a onetime designated amount that are not determined on the deceased employee's age, length of service, or prior contributions to Plan. The IRS concluded:

1. Plan benefits paid to a qualifying beneficiary are paid in the nature of a worker's compensation act and are excludable from the beneficiary's gross income;
2. Contributions made by the general public to fund the plan may be deductible by donors as charitable contributions provided that all other applicable requirements of §170 are met.

Disability Benefits Received after Normal Retirement Age are Partially Taxable (PLR 201315001)

Section 104(a)(1) excludes from gross income amounts received by an employee under a workmen's compensation act or under a statute in the nature of a workmen's compensation act that provides compensation to the employee for personal injury or sickness incurred in the course of employment. However, for an employee who has reached normal retirement age and who receives the normal service allowance, the portion of the employee's benefit that exceeds the disability benefits will be gross income to the recipient under §72.

See also: PLR 201317007 for Police and Fire Fighters.

ADJUSTMENTS TO GROSS INCOME

HEALTH SAVINGS ACCOUNTS

Health Savings Accounts - How Much May Be Contributed to an HSA (Rev. Proc. 2012-26; Rev. Proc. 2013-25)

Two types of contributions may be made to HSAs, regular and catch-up. Both have annual limits:

	2013		2014	
	Family	**Self only**	**Family**	**Self only**
Minimum health insurance deductible	$2,500	$1,250	$2,500	$1,250
Maximum out-of-pocket	$12,500	$6,250	$12,700	$6,350
Contribution limit	$6,450	$3,250	$6,550	$3,300
Additional catch-up contribution for taxpayer age 55 or older	$1,000 per qualifying spouse	$1,000	$1,000 per qualifying spouse	$1,000

Catch-up contributions may be made by individuals who are at least 55 years of age but not yet enrolled in Medicare. For years beginning on or after January 1, 2009, an additional $1,000 may be contributed. Currently, there is no provision in the law to increase the catch-up contributions beyond the $1,000 amount and there is no inflation indexing.

> **Preparer note**. Catch up contributions may be made only to a person's own individual HSA account. Therefore, a person may not make catch-up contributions to a family HSA in his or her spouse's name (Notice 2008-59, Q. 22). For example, a wife cannot contribute a catch-up contribution to a family HSA in the husband's name. She would have to open her own separate HSA.

Annual Contribution Limits Vary Based on Circumstances

Married couples are limited to one maximum HSA family contribution amount ($6,550 in 2014) regardless of whether each spouse has a self only or family HSA. For example, if husband has a self only HSA and wife has a family HSA, the maximum 2014 HSA contribution is $6,550 and is split evenly between the spouses unless they agree to split the amount otherwise.

Penalty on HSA Nonqualified Distributions

There is an additional tax on distributions from an HSA that are not used for qualified medical expenses of 20% of the disbursed amount. The penalty is waived in cases of disability or death and for individuals age 65 and older. There are no minimum required distributions from HSA, regardless of the account owner's age.

QUALIFIED STATE TUITION PROGRAMS §529

§529 Can Be a Gift Tax Planning Device (529 Plans: Questions and Answers)

The estate and gift tax rules applying to educational IRAs also apply to contributions to qualified tuition programs. Contributions to a qualified tuition program will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the present law gift tax exclusion provided by §2503(b) and also are excludable for purposes of the generation skipping transfer tax, provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift tax exclusion limit of $14,000, or $28,000 in the case of a married couple in 2014.

> **Planning idea.** For more information, see www.niccp.com and www.savingforcollege.com.

Special rule for contributions exceeding $14,000/$28,000 limit ($70,000/$140,000 for five-year gift). If a contribution in excess of $14,000 ($28,000 in the case of a married couple) is made in one year, the contributor may elect to have the contribution treated as if made ratably over five years beginning in the year the contribution is made.

Under this rule, a donor may contribute up to $70,000 every five years ($140,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made from the donor to the beneficiary in the five-year period. A gift tax return must be filed with respect to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor's gift tax return. If a donor making an over $14,000 contribution dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is includible in the donor's estate.

> **Planning idea.** As discussed elsewhere, the 3.8% Net Investment Income tax can be avoided if the income is used tax-free for college expenses.

Losses in the §529 plan account. Are losses deductible if the §529 account balance has dropped below the donor's contributions? While the IRS has not provided an answer to this question, you can find some nonauthoritative guidance at www.savingforcollege.com. It seems that if the donor closes the §529 plan for the beneficiary, losses may be deductible, but they are Schedule A miscellaneous itemized deduction subject to 2% of AGI limitations and, of course, the AMT preference impact.

COVERDELL EDUCATION SAVINGS ACCOUNTS (§530)

Expanded Coverdell Accounts Made Permanent (American Taxpayer Relief Act of 2012).

Coverdell Education Savings Accounts are tax-exempt savings accounts used to pay for education expenses of a designated beneficiary. The annual contribution limit is $2,000. The definition of education expenses includes elementary and secondary school, as well as college expenses. ATRA made Coverdell accounts permanent.

QUALIFIED HIGHER EDUCATION EXPENSE DEDUCTION

Tuition Deduction Expired Dec. 31, 2013 (§222; The American Taxpayer Relief Act of 2012)

Through 2013 qualified taxpayers are allowed an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Taxpayers with AGI not exceeding $65,000 ($130,000 in the case of married taxpayers filing joint returns) are entitled to a maximum higher education ***tax deduction*** of $4,000 ***and*** taxpayers with AGIs that don't exceed $80,000 ($160,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $2,000. Taxpayers with adjusted gross income above these thresholds are not entitled to this deduction. This deduction is not allowed if the American Opportunity Tax Credit produces a lower tax.

EDUCATOR DEDUCTION

$250 "Above-the-Line" Deduction for Classroom Materials Expired Dec. 31, 2013 (§62(a)(2)(D); The American Taxpayer Relief Act of 2012)

Above-the-line deduction for certain expenses of elementary and secondary school teachers. The $250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and service), other equipment, and supplementary materials used by the educator in the classroom has been extended through 2013.

ALIMONY/SEPARATE MAINTENANCE/DIVORCE

Property Settlement vs. Alimony (§1041)

Generally, no gain or loss is recognized on transfers of property between spouses or on transfers of property to a former spouse that are incident to a divorce (§1041(a); §1041(d)). This tax-free §1041 transfer is treated as a gift, meaning that neither spouse recognizes any income as a result of the transfer. The carryover basis rules apply. Alimony, on the other hand, creates both income and deductions. Determining if the transfer of property is property settlement or alimony can often be difficult, depending on the intent of the parties. In 1984 to eliminate the questions plaguing the courts concerning the taxpayers' intent and the nature of payments, Congress amended §71 in favor of the following six objective tests (including the child support override rule). If a payment satisfies all of these factors, then the payment is alimony; if it fails to satisfy any one of these factors, then the payment is not alimony.

Introduction to Alimony Deduction/Income (§71 & §215)

Alimony and separate maintenance payments are deductible from income by the payor spouse under §215 if includible in income of the payee spouse under §71. As previously discussed, property settlement payments are deemed gifts (§1041) between spouses and never create income or deductions. But, if the following specific requirements are met, a payment received by, or on behalf of, the payee spouse (or former spouse) qualifies as an alimony or separate maintenance payment:

1. Payment in cash (transfer of property or services do not qualify).
2. Received by spouse (or on behalf of spouse – i.e., indirect alimony).
3. ***Received under divorce or written separation agreement (i.e., no voluntary payments).***
4. ***Not alimony if agreement designates payments as excludable from payee spouse's gross income.***
5. Payee and payor spouse cannot live together (no joint return).
6. ***Alimony must stop after payee spouse's death (state statutes may require if agreement silent).***

7. ***Recapture may be required if "excess front-loading" (i.e., if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000 and to the extent the payments in the second year exceed the payments in the third year by more than $15,000).***

Requirement #3: Divorce or written separation agreement. Unfortunately, the term "written separation agreement" is not defined in the Code, the Regulations, or in the legislative history.

Requirement #4: What is a designated nonalimony payment? A payment is not to be treated as alimony if it is designated as nonalimony (§71(b)(1)(B)).

Requirement #6: Three tests determine if payments end at death. Courts have applied the following three-step approach to determining whether payments cease at the death of the payee spouse (§71(b)(1)(D)). The court first looks for an unambiguous termination provision in the divorce decree. If there is no such provision, then the court looks to whether the payments would terminate at the payee's death by operation of state law. And if state law is unclear, the court will again look solely to the divorce decree to determine whether the payments would terminate at the payee's death (*Kean* , 407 F.3d 186, 191 (3d Cir. 2005), aff'g TCM 2003-163; *Fithian v. U.S.*, 45 Fed. Appx. 700, 701 (9th Cir. 2002); *Lovejoy*, 293 F.3d 1208, 1212-1213 (10th Cir. 2002), aff'g TCM 1999-273; *Hoover*, 102 F.3d 842, 847-848 (6th Cir. 1996), aff'g TCM 1995-183; *Leventhal*, TCM 2000-92).

States that require payments to cease at death:

- # **California:** *Michael K. Berry v. Comm.*, TCM 2005-91 & *Carol A. Johanson v. Comm.*, TCM 2006-105
- # **Delaware:** *Mark A. Crompton v. Comm.*, TCS 2008-102
- # **Illinois:** *Nada Nahhas v. Comm.*, TCS 2007-28; (but other courts have determined the opposite, see list below)
- # **Kansas:** *Steve Le v. Comm.*, TCM 2008-183, where obligation to make delinquent temporary spousal maintenance payments end at death.
- # **Missouri:** *Ewald & Betty Jean Altmann v. US*, (DC Mo.), 2003-1 USTC ¶50,217 (but see in list of states that don't have these provisions)
- # **Montana:** Even though not adjudicated by a Tax Court, Montana's law states: "unless otherwise agreed in writing or expressly provided in the decree the obligation to pay future maintenance is terminated upon the death of either party or the remarriage of the party receiving maintenance" (40-4-208).
- # **Nebraska:** *Marlin G. Springer v. Comm.*, TCM 2003-221
- # **New Jersey:** *Michael Robert Peterson v. Comm.*, TCS 2003-122
- # **New York:** *Sandra J. Wolf v. Comm.*, TCS 2005-150
- # **Ohio:** *Kim J. Reid v. Comm.*, TC Memo 2008-177
- # **Tennessee:** (*Joyce A. Perkins v. Comm.*, TCM 2008-41)

States that do NOT require payments to cease upon death:

- **#** **Florida:** *Margaret Carol Burns v. Comm.*, TCS 2007-43 *Tyrone Sharp v. Comm.*, TCS 2004-27, *Charles W. Smith v. Comm.*, TCS 2003-167, *Lawrence Robert Gamer v. Comm.*, TCS 2003-166
- # **Georgia:** *Thomas Lettieri v. Comm.*, TCS 2007-114

- # **Illinois:** *Sara Lynn Williamson v. Comm*., TCS 2009-24; .*Zakrzewski v. Comm*., TCS 2007-97; *Charles Horton Devers v. Comm*., TCS 2006-128 (but other courts have determined the opposite, see list above)
- # **Missouri:** *Charles Horton Devers v. Comm*., TCS 2006-128
- # **Pennsylvania:** *Jane Gilbert v. Comm*. and *Richard C. Hawley, v. Comm*., TC Memo 2003-92
- # **Tennessee:** *Michael Wayne and Joan Elizabeth Bedwell v. Comm*., TSC 2008-139; *Paul H. Rogers v. Comm*., TCM 2005-50, (but other courts have determined the opposite, see list above)
- # **Texas:** *William Franklin Salzman II v. Comm*., TCS 2007-190

Requirement #7: Lump-sum alimony payments. In addition to the six general alimony rules, to prevent disguised property settlements from being deducted as alimony, a special three-year front-loading rule provides for the recapture of excess amounts previously treated as alimony (§71(f)).

If alimony payments are reduced or terminated during the first three years, excess front-loading rules may require recapture of a portion of the payments. When alimony payments are reduced or terminated during the first three post-separation years, recapture rules may apply. The payor-spouse is required to include in income in the third post-separation year any excess payments made in the first two years; the payee-spouse receives reciprocal deductions. Excess payments are (1) the excess of second-year payments over the third-year payments, plus $15,000, and (2) the excess of the first-year payments over the average of the second-year payments not recaptured in (1) and the third-year payments, plus $15,000. Special rules apply to divorce and separation instruments executed during 1985 and 1986.

Lump sum payment may qualify as alimony. As long as the alimony rules are followed, (i.e., no "excess-loading" existed, involuntary payments were made under a divorce decree, agreement stipulated that payments are deducible by the payor-spouse and included in the recipient's income, payments terminate at death of the recipient, and spouses were divorced, lived separately, and did not file joint income tax returns), the lump-sum payment made by the payor-spouse to the former spouse was alimony or separate maintenance and, thus, was deductible by the payor-spouse (LTR 200329003).

Payments related to taxpayer's income. The front-end loading rules do not apply if (1) the payor spouse agrees to pay a fixed portion of income from a business, property or compensation over a period not less than three years, and (2) either spouse dies or remarries before the end of the third year (§71(f)(5)).

Child support. Payments are not alimony if the agreement fixes part of any payment for a child's support (1) in dollar amounts, or (2) percentage. A payment is child support (not alimony) if a reduction occurs at a time "clearly associated with a contingency" (this is a presumption only). Examples of a clear contingency include (a) reduction occurring six months before or after age 18, 21, or majority, (b) reduction occurring more than one year before or after two or more children reach the same age, and (c) the child (1) attaining a specified age, (2) dying, (3) leaving school, (4) marrying, (5) leaving home, or (6) gaining employment (Temp. Reg. §1.71-1T(c)). If underpayments are made, the underpayment is deemed to go to child support first (§71(c)(3)).

#3: Nebraska Taxpayer Denied Alimony Deduction Because No Written Separation Agreement Existed (*James J. Faylor v. Comm*., TCM 2013-143)

Nebraska resident James Faylor separated from his wife, Mary Faylor, in May 2007. From July through December 2007 James and Mary exchanged several written proposals through their respective attorneys regarding the terms of a temporary support agreement. While it appeared that James and Mary may have reached a general consensus of the terms of a temporary support agreement in December 2007, nothing was ever signed or agreed to in writing. On his 2008 tax return, James deducted alimony of $36,500: $20,000 of temporary support for January through April and $16,500 of court ordered alimony for May through December. The IRS conceded the alimony of $16,500 for the last 3/4s of the year was deductible, but disallowed the $20,000 of temporary support for the first quarter of the year because it was not paid under a "written separation agreement."

"Written separation agreements" do not include draft agreements. For a payment to qualify as alimony it must be paid under a divorce or written separation agreement. The Court noted that while James and Mary exchanged drafts of proposed temporary support orders, they did not agree to each other's drafts and neither of them signed the drafts. The Court, accordingly, ruled that the correspondence between James and Mary did not establish the existence of a written separation agreement as there was no evidence proving there was a meeting of the minds between the Faylors (see also *Nemeth v. Comm.*, TCM 1982-646).

> **Planning idea.** It didn't help James's argument when Mary Faylor testified at his tax trial that she and James did not come to an agreement and that she did not sign either of the proposed temporary support orders because she did not agree to all of the terms. Lesson here—don't expect a lot of support from an ex-spouse, especially on the witness stand!

See also. #3: *Daniel Martin v. Comm.*, TCS 2013-31, where taxpayer was denied deduction for increased amount of alimony payments where judgement of dissolution was not modified to reflect the increase and no other written agreement was in evidence.

#4: Payment was for Equalization of Distribution of Marital Assets, Not Alimony (*Roscoe Jerome McNealy and Leana Yvonne McNealy v. Comm.*, TCS 2014-14)

Requirement #4: What is a designated nonalimony payment? A payment is not treated as alimony if it is designated as nonalimony (§71(b)(1)(B)).

Payment was to equalize the distribution of martial assets. On April 6, 2009, Mr. McNealy and the former Mrs. McNealy entered into a marital settlement agreement. The marital settlement agreement states in pertinent part as follows:

> MUTUAL WAIVER OF ALIMONY. Neither party shall claim any entitlement to any alimony award from the other now or in the future or be obligated to make alimony payments to the other. Each party waives all rights to alimony of any nature which he or she may have under the laws of the State of Florida or any other state. Each party understands that once having waived alimony, he or she may not institute a claim for alimony at a later date.
>
> EQUITABLE DISTRIBUTION. The parties agree that all marital debts and assets shall be equitably divided pursuant to the equitable distribution spreadsheet attached hereto * * *.
>
> EQUALIZATION PAYMENT. As and for equalization of the distribution of marital assets, the Husband shall pay to the Wife the net sum of Forty Thousand and No/100 Dollars ($40,000.00) on or by July 1, 2009. * * * Said payment shall be made directly to the Wife by certified check or money order.

Payment not an alimony deduction. On Mr. McNealy's 2009 Form 1040 for 2009, he claimed a $40,000 alimony deduction for the equalization payment. The IRS disallowed the deduction. The court held that the marital settlement agreement made it clear that the equalization payment was intended to ensure the equitable division of the property. Because property settlements (or transfers of property between spouses) incident to a divorce are neither taxable events nor give rise to deductions or recognizable income pursuant to §1041, Mr. McNealy's $40,000 equalization payment to the former Mrs. McNealy was not an alimony payment. In addition, the marital settlement agreement expressly stated it was binding upon the parties, their personal representatives, successors, and assigns for all time. Thus, the payment would not have terminated upon the death of the ex-wife, another requirement for a payment to be alimony (see §71(b)(1)(D)).

See also. #4: *Emmanuel C. Kouskoutis pro se. v. Comm.*, TCS 2012-64, payments not alimony because agreement specifically designated payments as excludable from payee spouse's gross income.

#6: Family Support Payment without Allocation to Child Support is Deductible Alimony (*Brendon DeLong pro se. v Comm.*, TCM 2013-70)

Brendon and Tamsin DeLong separated in 2006 and filed for divorce in 2007. While the divorce case was pending, Brendon was ordered to pay Tamsin family support payments of $3,000 per month. The court indicated that the family support payments were for both spousal support and child support. The support agreement did not allocate any specific portion of the family support payments as spousal support or child support, nor did the Court's order explicitly contain a condition that would terminate Brendon's obligation to make the family support payments at Tamsin's death.

IRS claimed payments were designated as nonalimony and did not terminate at death of the payee spouse. The IRS disallowed the alimony deduction contending that the family support payments failed to satisfy the general alimony requirements because they were designated as nonalimony and that Brendon's liability to make them would have continued past Tamsin's death.

Three tests determine if payments end at death. As cited above, the IRS also argued that the family support payments did not end at Tamsin's death. Courts have applied the following three-step approach to determining whether §71(b)(1)(D) is satisfied. The court first looks for an unambiguous termination provision in the divorce decree. If there is no such provision, then the court looks to whether the payments would terminate at the payee's death by operation of state law. And if state law is unclear, the court will look solely to the divorce decree to determine whether the payments would terminate at the payee's death.

What does state family law say? The support order did not expressly state that Brendon's liability for making the family support payments would terminate on Tamsin's death. However, California law clearly provides that "spousal" support obligations terminate upon the death of the payee spouse. While "family" support payments are not specifically addressed under California law, a recent court case held that family support obligations did not continue past the death of a payee spouse (*Michael K. Berry v. Comm.*, TCM 2005-91). Thus, Brendon was entitled to an alimony (spousal support) deduction for his family support payments.

#6: Lump Sum Payment of Alimony Not Deductible Unless Obligation Ends at Recipient Spouse's Death; Oregon Law Comes to the Rescue (*Bradley W. Wignall v. Comm.*, TCM 2014-22)

Brad Wignall's marriage to Marci Wignall ended in 2006. The divorce decree required Brad to pay Marci spousal support of $1,900 per month from July 2006 through December 2011. Brad paid $21,000 of spousal support in 2008 which he deducted as alimony on his income tax return. Nothing in the decree addressed whether the spousal support payments ended if Marci died before December 2011.

Courts use three step process to determine if payments end at death. To determine if alimony payments stop at the recipient spouse's death, courts first look for an unambiguous termination provision in the divorce decree. If there is no such provision, courts next look to whether the payments would terminate at the payee's death by operation of state law. If there is still no resolution, courts look solely to the divorce decree and related law to determine whether the payments would terminate at the payee's death.

Oregon Supreme Court comes to the rescue. Brad and the IRS agreed that the decree did not expressly terminate Brad's obligation to continue payments if Marci died. The also agreed, and the Court concurred, that Oregon law did not specifically address the issue. Thus, the ruling came down to whether Oregon common law would terminate Brad's obligation to pay spousal support upon Marci's death under the terms of the divorce decree. Brad, citing *Prime v. Prime*, 139 P.2d 550, 554 (Or. 1943), argued that the Oregon Supreme Court previously held that the right to receive alimony and the corresponding duty to pay it are generally considered to terminate on the death of either of the two parties, at least where no statute to the contrary exists and the judgment or decree is silent on the subject. The Tax Court agreed and ruled that Brad was entitled to deduct the 2008 support payments as alimony.

> **Planning idea**. The more specific the family court order is, the less time the taxpayer will spend in court defending a spousal support deduction.

STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

STANDARD DEDUCTION §63

Standard Deduction (Rev. Proc. 2013-35)	2013	**2014**	2015
Married Filing Joint & Qualifying Widow(er)	$12,200	**$12,400**	
Head of Household	$8,950	**$9,100**	
Single	$6,100	**$6,200**	
Married Filing Separate	$6,100	**$6,200**	

Additional Standard Deduction for Elderly and Blind

For a taxpayer (or spouse) who is age 65 or over or blind, the following applies:

1. **Unmarried Taxpayer.** An additional $1,550 ($1,500 in 2013) standard deduction amount is allowed, $3,100 ($3,000 in 2013) for a taxpayer both elderly and blind in 2014.

2. **Married Taxpayer.** An additional $1,200 standard deduction amount is allowed, $2,400 for a taxpayer both elderly and blind in 2014 (and 2013).

Standard deduction for dependents. If an individual *may* be claimed as a dependent on another's return (i.e., the exemption is "allowable" by another taxpayer), the dependent's basic standard deduction is limited to the *lesser* of (§63(c)(5)):

1. The basic $6,200 standard deduction for single taxpayers, *or*
2. The *greater* of $1,000 or the dependent's earned income plus $350 (in 2014 and 2013).

Preparer note. Dependents must file their own return if unearned income exceeds $1,000 (for 2014 and 2013) (unless the parents are eligible to and, by special election, report the income on their return) or their gross income exceeds their standard deduction (Pub 17).

ITEMIZED DEDUCTIONS

Itemized Deduction Limitation Returns (§68(a); (American Taxpayer Relief Act of 2012 (P.L. 112-240); Rev. Proc. 2013-35)

In 2012, all taxpayers were allowed to deduct 100% of their itemized deductions. Beginning in 2013, itemized deductions are limited for relatively high income taxpayers. In the case of an individual whose adjusted gross income exceeds the "applicable amount," the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the **lesser** of:

1. 3% of the excess of adjusted gross income over the applicable amount, in excess of the threshold amount, which is annually adjusted for inflation (§68(b)(2)), or
2. 80% of the amount of the itemized deductions otherwise allowable for such taxable year (§68(a)).

For 2014, the AGI threshold amounts are (§68(b)):

Filing status	2014 AGI to begin phaseout*	2015 AGI to begin phaseout*
Married filing joint	$305,050	
Head of household	$279,650	
Single	$254,200	
Married filing separate	$152,525	
*Annually adjusted for inflation		

Example. Dave and Carol file jointly and have AGI of $500,000. Because their AGI exceeds $305,050, Dave and Carol's 2014 itemized deductions will be reduced by $5,849 (3% of AGI over $305,050 but not more than 80% of the allowable itemized deductions). Assuming they are in 35% tax bracket, Dave and Carol will pay $2,047 of additional tax in 2014.

For this calculation, the term "itemized deductions" does not include:

1. the deduction under §213 (relating to medical, etc. expenses),
2. any deduction for investment interest (as defined in §163(d)), and
3. the deduction under §165 (a) for casualty or theft losses (as described at §165)(c)(2) or (3)) or for §165(d) gambling losses (§68(c)).

STANDARD MILEAGE RATES

The 2014 Standard Mileage Rate for Medical, Moving, and Charity (Notice 2013-80)

The IRS provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred for operating a passenger automobile. In addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate. The 2014 medical and moving standard mileage rate is 23.5¢ per mile. The rate for charitable miles remains at 14¢. The IRS generally updates in December for the following year; for example, the IRS is scheduled to release the standard mileage rates for 2015 in December of 2014.

	2013	**2014**	2015
Medical and moving	24¢	**23.5¢**	
Charity	14¢	**14¢**	
Business	56.5¢	**56¢**	

MEDICAL, DENTAL, ETC., EXPENSES §213

Medical AGI Haircut Increased to 10% Beginning in 2013

The threshold for the itemized deduction for unreimbursed medical expenses increased from 7.5% in 2012 to 10% of AGI in 2013 and thereafter. If either the taxpayer or the taxpayer's spouse is 65 or older before the end of the taxable year, the AGI haircut does not increase to 10% of AGI until 2017.

> **Preparer note**. Regular tax and AMT now use the same 10% of AGI limitation for medical expense deductions.

Deductible Medical Expenses

The term "medical care" means amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (§213(d)(1)(A)). The regulations restrict that definition by stating "deductions for expenditures for medical care allowable under §213 will be confined ***strictly*** to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness." Examples of medical care include: hospital services, nursing services, laboratory, surgical, dental and other diagnostic and healing services, medicine and drugs, artificial teeth or limbs, and ambulance hire. In addition, amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care (§1.213-1(e)(1)(ii)).

Nondeductible Medical Expenses
General health expenditures. An expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care. Other nondeductible items include:

- Nonprescription drugs and medicines (§213(b))
- ***Nutritional supplements, vitamins, herbal supplements, natural medicines, weight-loss programs, etc. unless recommended by a medical practitioner as treatment for a specific medical condition diagnosed by a physician (Pub. 502)***
- Dancing lessons (*I. A Adler v. Comm.*, 22 TCM 965)
- Diaper service (Pub. 502)
- Health club dues (§274(a)(3))
- Household help (Pub. 502)
- Personal use items, including maternity clothes, toothpaste, etc. (*M.C. Montgomery v. Comm.*, 51 TC 410, (CA-6) 70-2 USTC ¶9466)

Long-Term Care Premium Limits

Annual long-term care insurance premiums are deductible as medical expense up to:

Age of Individual Before Close of Tax Year	**Maximum Deductible Premium (Rev. Proc. 2013-35)**		
	2013	**2014**	2015
Not more than 40	$360	**$370**	
More than 40 but not more than 50	680	**700**	
More than 50 but not more than 60	1,360	**1,400**	
More than 60 but not more than 70	3,640	**3,720**	
More than 70	4,550	**4,660**	

Medical Benefits for Children Under 27 (TR §54.9815-2714T; TD 9482; REG-114494-10.; Notice 2010-38)

Medical insurance premium deductible even when child under 27 is not a dependent. The general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan has been extended, effective as of March 30, 2010, to any child of an employee who has not attained age 27 as of the end of the taxable year.

Self-employed can take advantage of this rule. Self-employed individuals are also permitted, under §162(l) to take a deduction for SE health insurance for any child of the taxpayer who has not attained age 27 as of the end of the taxable year. However, the self-employed may not claim the deduction for the cost of health care insurance if the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of a taxpayer's dependent or a child of the taxpayer who is under 27 at the end of the tax year.

Dependency not required. It is not necessary for the child of the employee to be a dependent of the employee in order for this medical exclusion to apply. If the child is age 26 or less at the end of the tax year, the exclusion applies even when:

- the child provides more than half of his or her own support;
- earns more income than the exemption amount ($3,950 in 2014);
- does not live with the taxpayer; or
- any other restriction applies which would prevent the employee from claiming a dependency exemption for the child either under the qualifying child rules or the qualifying relative rules.

Definition of a child. For purposes of the provision, "child" means an individual who is a son, daughter, stepson, stepdaughter, or eligible foster child of the taxpayer. An eligible foster child means an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

Insurance companies no longer allowed to use tax dependency rules to determine insurance eligibility. Insurance issuers offering group health insurance coverage that covers dependent children must make such coverage available for children until attainment of 27 years of age. The plan or insurance issuer may not deny or restrict coverage for a child who has not attained age 27 regardless of the child's financial dependency upon the insured, student status, employment, residency with the insured, or any combination thereof (TR §54.9815-2714T; TD 9482; REG-114494-10).

Flexible Spending Account (FSA) May Allow Carryovers of Unused Amounts to Future Years (Notice 2013-71)

New carryover allowed but not required. At the plan sponsor's discretion, §125 cafeteria plans may, but are not required, to offer plan participants a carryover of up to $500 from a health FSA from the current year to the following plan year. While carryovers were not previously allowed, §125 plans could allow employees to carry amounts from a previous year (including amounts remaining in a health FSA) to pay expenses incurred for qualified benefits for up to two months and 15 days immediately following the end of the plan year (the "grace period").

> **Preparer note.** §125 cafeteria plans may offer the $500 carryover or the 2½ month grace period but may not offer both.

Carryover does not reduce current year allowable amount. The carryover of up to $500 does not affect the maximum amount of salary reduction contributions that the participant is permitted to make under §125(i) ($2,500 for 2014).

TAXES §164

Deduction of State and Local General Sales Tax Deduction Expires Dec. 31, 2014 (American Taxpayer Relief Act of 2012)

Claiming sales tax instead of income tax deduction. ATRA of 2012 extended through 2013 the election to take an itemized deduction for State and local general sales taxes in lieu of the itemized deduction permitted for State and local income taxes. Taxpayers were able to deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively taxpayers may use optional sales tax tables created by the IRS (see Pub. 600). Taxpayers also may add to the table amount any sales taxes paid on: a motor vehicle, but only up to the amount of tax paid at the general sales tax rate; and an aircraft, boat, home (including mobile or prefabricated), or home building materials, if the tax rate is the same as the general sales tax rate.

INTEREST §163

Background and Purpose of Home Mortgage Interest Deduction (CRS Report R43385; Jan. 30, 2014)

The home mortgage interest deduction can generally be viewed as government spending administered via the tax code, or as tax incentives that are intended to achieve particular policy objectives, in this case providing a benefit to qualifying taxpayers by lowering their federal tax liabilities (by an average of approximately $1,906 in taxes in 2012). But, large variations exist state by state because of differences in homeownership rates, home prices, state and local tax policies, and area incomes. In addition, the value of the deduction increases with the increase of the individual's marginal income tax rate and the purchasing of more expensive homes.

Factoids: to see each state, click the CRS report hyperlink in the heading, which illustrates the below facts using a national map.

1. The home mortgage deduction was claimed on 25% of tax returns nationally; with South Dakota having the lowest rate, 14%, and Maryland having the highest rate, 35% (Figure 2).
2. Only about half of all homeowners nationally (48%) claim the deduction; the distribution generally the same as in #1 (Figure 3).
3. D.C. filers who claimed the home mortgage deduction received the largest average benefit ($3,272), followed by California ($2,974). Homeowners in Ohio received the smallest benefit ($891), followed by Iowa ($1,177). In other words, D.C. tax filers realized a tax liability reduction nearly four times that of Ohio filers (Figure 4).
4. Homeownership rates varied across states from a low of 41.2% in D.C. to a high of 72.8% in Minnesota in 2011 (Figure 5).
5. As state and local income and property taxes increase, all else equal, it becomes more likely that homeowners will claim the mortgage interest deduction in lieu of using the standard deduction. It is less likely in the nine states with no broad-based income tax, including Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming.

Proposals to eliminate, limit, or change the home mortgage deduction. The deduction is commonly thought to promote homeownership, which may produce desirable social spillovers. The economic research on the ability of the deduction to increase homeownership and produce social spillovers, however, generally suggests that the deduction does not achieve the often stated policy objective of increasing homeownership. Therefore, the CRS report contains a discussion on eliminating the deduction which would promote a more uniform tax treatment across taxpayers, especially between homeowners and renters and homeowners in different states. Another option is to limit the maximum mortgage amount, for example $500,000, or limit it to a percentage of the homeowner's AGI, such as 10%, 12%, or 15%. A third discussed option is to replace the deduction with a maximum tax credit, for example 15%. which could provide a benefit to more homeowners since itemization would not be required and would have the same dollar-for-dollar value regardless of income. In addition, make the tax credit refundable would better target lower-income homeowners.

Qualified Residence Debt Limitations (§163(h)(3)(B))

> **Comment.** According to the General Accounting Office, the IRS has directed its attention, and audit resources, toward the home mortgage interest deduction. Specifically, it is trying to determine if the taxpayer is violating the $1 million limit. In addition, it is matching Form 1098 reported mortgage interest payments to the taxpayer's Schedule A.

There are two major categories of home mortgages. They are:

1. Mortgages taken out after October 13, 1987, to buy, build, or improve the taxpayer's home (called ***home acquisition debt***), but only if throughout the calendar year these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately);
2. Mortgages taken out after October 13, 1987, other than to buy, build, or improve the taxpayer's home (called ***home equity debt***), but only if throughout the calendar year these mortgages totaled $100,000 or less ($50,000 or less if married filing separately) ***and*** totaled no more than the fair market value of the home reduced by home acquisition debt.

Interest paid on the main residence or second home is deductible. A taxpayer can have only one main residence at any one time, and it will ordinarily be where he or she lives the majority of the time (§1.163-10T(p)(2)). A second home is a home that the taxpayer chooses to treat as his or her second home. A taxpayer cannot have more than one second residence at a time (§1.163-10T(p)(3)).

Mortgage insurance premiums (a.k.a. PMI) deduction expires Dec. 31, 2013 (§163(h)(3)(E)). The cost of mortgage insurance on a qualified residence is deductible as an itemized deduction. Premiums paid by the taxpayer for qualified mortgage insurance during the taxable year in connection with acquisition indebtedness with respect to a qualified residence are treated as qualified residence interest, and are, therefore, deductible as mortgage interest. The deduction is phased out ratably by 10% for each $1,000 ($500 for MFS) by which the taxpayer's AGI exceeds $100,000 ($50,000 for MFS). Thus, the deduction is unavailable for a taxpayer with an AGI in excess of $110,000. Only premiums paid before January 1, 2014 qualify. Only premium payments for the current year qualify for deduction. If the taxpayer makes lump sum or multi-year premium payments, they must be amortized over the shorter of the term of the loan or 84 months (Temp. Reg. §1.163-11T; Notice 2008-15).

What exactly is a qualified residence? A residence may include a house, condominium, cooperative, mobile home, house trailer, boat, or similar property; a second residence must contain sleeping, cooking, and toilet facilities (§1.163-10T(p)).

The collateral must be correct. Residence mortgage interest is deductible only if the mortgage is properly secured and collateralized. A secured debt is one in which there exists a signed instrument (such as a mortgage, deed of trust, or land contract) that:

1. Makes the taxpayer's ownership in a qualified home security for payment of the debt;
2. Provides, in case of default, that the home could satisfy the debt; and
3. Is recorded or is otherwise perfected under any state or local law that applies (§1.163-10T(o)(1)).

Interest on Loan From Family must be Perfected to Deduct Interest (*Yong J. Dong v. Comm.*, TCS 2014-4)

Yong Dong bought a home in New York in 2005. Yong entered into a loan agreement in 2007 with his parents that allowed Yong to borrow up $130,000. The loan agreement stipulated that Yong's interest in his home was the specific security for the payment of the debt. Although Yong and his parents had a written loan agreement and a deed of trust, neither document was recorded in any jurisdiction.

Interest deduction disallowed. Yong deducted interest he paid to his parents of $26,442 and $26,162 on his 2007 and 2008 tax returns, respectively. The IRS accepted that the loan agreement between Yong and his parents provided that Yong's New York home was specific security for the payment of the loan. The IRS, however, disallowed the mortgage interest deductions because neither the loan agreement nor the deed of trust were properly secured under state law.

Lack of recording dooms deduction. The Court ruled that, in the event of a default, Yong's unrecorded mortgage would not be sufficient to subject his residence to the satisfaction of the debt with the same priority as a recorded mortgage because the unrecorded mortgage is valid only against a third person having actual notice of it. The Court further determined that neither the deed of trust nor the loan agreement between Yong and his parents were perfected under New York state law and ruled the interest he paid to his parents was not deductible.

> **Planning idea.** If your client says his Dad lent him money to buy a house, check to see that the note is recorded or the interest that Son paid to Dad will not be deductible. If your client says that he has interest income to report because he lent his Son money to buy a house, remind the client that unless the loan is recorded against the house, the interest is not deductible for Son, but still taxable to Dad.

Cash Method Taxpayer Can Only Deduct Interest When Paid, Not Accrued (*Philip Smoker v. Comm.*, TCM 2013-56)

House payment didn't even cover the interest. Unpaid interest added to principal. Philip Smoker purchased his Michigan home with an adjustable rate mortgage. The terms of the mortgage provided that if the interest due was more than the stated mortgage payment, unpaid interest would be accrued to the mortgage balance. Mr. Smoker paid mortgage interest of $19,828 in 2006 and $21,316 in 2007 with respect to the Michigan property. The mortgage holder added accrued interest to the mortgage balance of $12,275 in 2006 and $15,973 in 2007.

Taxpayer deducted the deferred interest. Phil deducted the deferred interest that was capitalized into the principal of the mortgage, arguing he "paid" interest because adding accrued interest to the principal of a mortgage note is akin to taking out a second mortgage to pay the interest accrued and is thus indistinguishable in substance from borrowing from a third party to make the interest payments.

Accrued home mortgage interest not deductible until paid. It is well settled that a cash method taxpayer is allowed a deduction for interest paid during the taxable year in cash or its equivalent (*Davison*, 107 T.C. 35, 41 (1996), aff'd , 141 F.3d 403 (2d Cir. 1998); *Menz* , 80 T.C. 1174, 1185 (1983). The mere delivery of a promissory note to satisfy an interest obligation, without an accompanying discharge of the note, is a mere promise to pay and not a payment in a cash equivalent (*Don E. Williams Co.*, 429 U.S. 569, 577-578 (1977)).

Planning idea. If the taxpayer had borrowed money to pay the accrued interest, he would be entitled to the deduction. Simply adding to his existing mortgage is not a "payment."

Mortgage Interest on Refinance Deductible Only as Home Equity (*James S. and Carol S. Callahan v. Comm.*, TCM 2013-131)

Home purchased in 1998 refinanced in 2007 can't be called "acquisition" debt. James and Carol Callahan deducted home mortgage interest of $145,347 on their 2007 income tax return. The Callahans were able to establish that they paid $145,347 of interest on a mortgage that was properly secured by their residence. However, Carol Callahan acquired her home from her father in 1998. The Callahans waited until 2005 before obtaining a mortgage on the residence of $1.4 million. The Court concluded that the 2005 note was not acquisition indebtedness because Carol Callahan originally purchased the property without a loan and she and James failed to show that any of the proceeds from the mortgage were used to finance the construction or substantial improvement of any part of the home.

Interest attributable to $100,000 of home equity debt allowed. While the Court denied the Callahans' deduction for interest paid on acquisition debt, it did note that the mortgage qualified as home equity indebtedness and ruled that the Callahans were entitled to deduct a portion of $145,347 of mortgage interest paid to the extent that it is attributable to $100,000 of the mortgage debt.

Equitable Owner May be Entitled To Interest Deduction, Even If Not Legal Owner

Equitable owner. Mortgage indebtedness generally must be an obligation of the taxpayer and not an obligation of another (*Golder v. Commissioner*, 604 F.2d 34, 35 (9th Cir. 1979), aff'g TCM 1976-150). However, taxpayers who are not directly liable on a mortgage may nevertheless deduct mortgage interest paid if he or she is the legal or equitable owner of the property subject to the mortgage (§1.163-1(b)).

"Burden and benefit" indicators. Factors established by various tax courts to determine "equitable" ownership include:

1. Who has right to possess or use property?
2. Who pays property obligations such as taxes?
3. Who pays insurance?
4. Who maintains property?
5. Can property be improved without named borrower's consent?
6. Who has risk of loss?
7. May legal title be obtained simply by paying balance of full purchase price?
8. Can "equitable title" be issued under state law (*Blanche v. Comm.*, TCM 2001-63, affd. 33 Fed. Appx. 704 (5^{th} Cir. 2002))?

Mortgage Interest Deduction Denied for Home Owned by Brother (*Lourdes Puentes v. Comm.*, TCM 2013-277)

Lourdes Puentes claimed a mortgage interest deduction of $28,942 on her 2009 tax return. However, Puentes was not the legal owner as the house was titled in her brother's name. She argued she was the equitable owner.

Taxpayer had no evidence of ownership. The mortgage interest deduction was disallowed since Ms. Puentes offered no evidence that she had any agreement with her brother entitling her to an ownership interest in the home or any beneficial rights, such as the right to rents, the right to profits, the right to possession, the right to improve, or the right to purchase the home.

> **Preparer note**. Your client in this situation should consult with a real estate attorney so that an ownership agreement can be considered.

CHARITABLE CONTRIBUTIONS §170

Charitable Distributions from IRAs Expired Dec. 31, 2014 (American Taxpayer Relief Act of 2012 (P.L. 112-240))

Through 2013, an IRA owner age 70½ or over may directly transfer up to $100,000 per year to an eligible charitable organization. This provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Eligible IRA owners can take advantage of this provision, regardless of whether they itemize their deductions.

> **Planning idea**. Congress has now extended this law three times, each time at the end of the year following the year of expiration. The problem is that most taxpayers have already taken their RMDs by the time our tardy Congress decides to extend. To combat this problem in future years, practitioners should consider advising clients to make transfers to charities, even if the law has expired. Then, if Congress does extend, the taxpayer has complied and will benefit from the law change. If the law is not extended, the taxpayer has a taxable IRA distribution and a charitable contribution.

Some SIMPLE IRA or SEP IRA transfers to a charity may also qualify. Generally transfers can be made from any IRA to a charity. However, a restriction applies to transfers from SIMPLE IRAs or SEP IRAs. If the employer has made a contribution to the plan during the year, it does not qualify for the charity transfer. If the employee (account owner) is retired and contributions are no longer being made to the SIMPLE IRA or SEP IRA, then the account qualifies for the §408(d)(8)(A) rollover.

Trustee to charity transfer required. To qualify, the funds must be contributed directly by the IRA trustee to the eligible charity. Amounts so transferred are not taxable, and no deduction is available for the amount given to the charity.

Transfers are part of RMD. Transferred amounts are counted in determining whether the owner has met the IRA's required minimum distribution rules. Where individuals have made nondeductible contributions to their traditional IRAs, a special rule treats transferred amounts as coming first from taxable funds, instead of proportionately from taxable and nontaxable funds, as would be the case with regular distributions.

> **Planning ideas if IRA transfer extended for 2014.** Nonitemizers get the full benefit for the contribution ***and*** the full benefit of the standard deduction. The itemized deduction AGI phaseout is minimized, including both the 1% haircut and the 30%/50% charitable contribution base limitation. Maybe the income decreases for the 50%/85% Social Security income inclusion amount. And maybe the lower income reduces the means tested Medicare Part B premium in

another year. Lastly, it permanently eliminates future income with respect to a decedent and maximizes on-hand cash that would normally be given to the charity.

Required Documentation for Charitable Deductions Chart		
	Amount	**Required records**
C A S H	Single cash contribution of less than $250	Cancelled check, bank record, credit card statement, or written acknowledgment from the charity. §170(f)(17) ; IR-2006-192
	Single cash contribution of $250 or more	Written acknowledgment from the charity.§170(f)(8)
	Payroll deduction	Pledge card *and* W-2, paystub, etc. §1.170A-13(c); Notice 2008-16
N O N C A S H	Noncash contributions less than $250	Written acknowledgment from the charity or other reliable record. §1.170A-13(b)(1)
	Noncash contribution of $250 but not more than $500	Written acknowledgment from the charity. §1.170A-13(b)(3)
	Noncash contribution over $500 but not more than $5,000 §170(e)(12)	Written acknowledgment from the charity and Form 8283, part A. §1.170A-13(b)(3)
	Noncash contribution of over $5,000 of similar items	Written acknowledgment from the charity, appraisal and Form 8283, part B. §170(f)(11)(c)
	Noncash contribution of more than $500,000	Written acknowledgment from the charity, appraisal and Form 8283, part B. Attach appraisal to the return. §170(f)(11)(D)
O T H E R G I F T	Noncash contribution of auto, boat, or airplane with a value of more than $500	Written acknowledgment from the charity. Attach form 1098-C and Form 8283 to return. §170(e)(11)(c); IR-2006-192
	Noncash contribution of publicly traded stock	Written acknowledgment from the charity and Form 8283, part A. §1.170A-13 (c)(7)(xi)(B)
	Noncash contribution of privately traded stock of more than $5,000	Written acknowledgment from the charity, and Form 8283 part B. If the privately traded stock is valued at $10,000 or more, attach an appraisal to the return. §1.170A-13 (c)(2)(ii)(B)(1)
	Noncash contribution of art valued at more than $20,000	Written acknowledgment from the charity, appraisal, Form 8283, part B. Appraisal and a photo of the art must be attached to the return. Rev. Proc. 96-15.
The written acknowledgment must be received from the charity before the due date of the return (including extensions) and it must include a statement regarding goods and services received in exchange for the contribution.		

IRS Explains Documentation Rules for Contribution of Goods to Unattended Charity Drop Site (IR 2013-98)

Taxpayers are required to retain documentation for all donations of property, including clothing and household items. The IRS clarified in a news release that property donations left at a charity's ***unattended*** drop site may be substantiated if the taxpayer retains a written record of the donation that includes: (1) the name of the charity, (2) date of the contribution, (3) a reasonably-detailed description of the donated property, and (4) the fair market value of the property at the time of the donation and the method used to determine that value.

> **Preparer note.** A receipt from the charity is required if the contribution (cash or noncash) is valued at $250 or more. An appraisal is required if the noncash contribution is valued over $5,000. See Pub 526 for details on the many charity documentation rules.

Court Held that IRS Revenue Agent's Substantiation of Charitable Contributions to Church Were a "Cut-and-Paste" Job (*Margaret Payne v.Comm.* pro se, TCS 2013-64)

Margaret Payne was employed by the IRS in the Manhattan office as a revenue agent for 20 years and had been employed by the IRS for 28 years. The IRS audited her charitable contributions deduction. After she provided receipts for her cash contributions to the Living Stone Baptist Church, the auditor called up the church's Pastor to confirm the amount. The Pastor told the auditor that Margaret was not a member of his church, that he did not know her, and that she had not made any contributions to his church. When shown her receipts from the church, he stated that they were not signed by him and that the letterheads were a "cut-and-paste job" from another church member who worked with Margaret. Later, when testifying in court, the Pastor recanted his statement to the IRS auditor with three contradictory explanations, including that maybe Margaret was that other church member. The court rejected these later explanations and also rejected the receipts. The court concluded: "While the prevailing stories vary, one matter of which we are absolutely certain is that (Margaret) has not presented any credible evidence that she made these contributions."

> **Preparer idea**. Taxpayer's excuses don't matter. A proper charity receipt is needed for all contributions of $250 or more. Consider asking to see the receipt if client claims large charitable contributions.

Also see:

James S. and Carol S. Callahan v. Comm., TCM 2013-131, taxpayer had receipts for only $375 of their $1,300 of claimed deductions for cash charitable contributions. The Court limited the contribution deduction to $375 as the requirement for a written acknowledgment from the charity for the remaining amount was not met.
David Durden v. Comm., TCM 2012-140, where taxpayer denied deduction even after corrected receipt documenting contributions was obtained from charity because it wasn't obtained prior to filing of return.

IRS to Audit More Noncash Contributions (TIGTA 2013-40-009)

TIGTA estimated that more than 273,000 taxpayers claimed approximately $3.8 billion in potentially erroneous noncash charitable contributions in 2010, saving an estimated $1.1 billion in taxes.

Noncash donations of more than $5,000. TIGTA's statistical sample of 2010 tax returns that claimed more than $5,000 in noncash charitable contributions showed that approximately 60% of the taxpayers sampled did not comply with the noncash charitable-contribution reporting requirements. These taxpayers claimed noncash contributions totaling approximately $201.6 million. IRS plans to check more returns to ensure appraisals are attached when required.

Noncash Contributions Exceeding $5,000

Required documentation. For any noncash contribution exceeding $5,000, the regulations require the donor to:

1. obtain a qualified appraisal for the contributed property,
2. attach a fully completed appraisal summary (i.e., Form 8283) to the tax return on which the deduction is claimed, and
3. maintain records pertaining to the claimed deduction in accordance with §1.170A-13(b)(2)(ii) and §1.170A-13(c)(2).

Appraisals Not Good Enough to Substantiate Value of Donated Apartment Building *(Ben Alli and Shaki Alli v. Comm*., pro se, TCM 2014-15)

Ben Alli is an M.D. and Ph.D. In 1983, the Allis purchased two apartment buildings, 2211 Pingree (Pingree) and 2987 Gladstone (Gladstone) from HUD at an auction for a total of $353,000.

Apartment building donated to charity. On September 29, 2008, Dr. and Mrs. Alli executed a quitclaim deed of Gladstone to Volunteers of America, Michigan for nominal consideration (i.e., $1). At the time of the donation, only 6 of Gladstone's 34 apartment units had tenants due to a protracted dispute with HUD regarding the "deplorable" condition of the rental units.

Charity promptly sold property for $60,000. Volunteers of America quickly entered into a contract on September 10, 2008, to sell Gladstone to an investor in California for $60,000. This investor was the only person who expressed interest in purchasing Gladstone.

Taxpayers claimed FMV was $499,000. The Allis reported the charitable contribution of Gladstone on Form 8283 of their 2008 return. On the Form 8283, the taxpayers described Gladstone as a "34 Unit Apartment Building" in "Good Condition" with an appraised fair market value of $499,000. The Allis further reported their basis in Gladstone was $1,200,000.

Form 8283 did not include appraiser's or donee's signature. The Form 8283 did not include an appraiser's name, address, or identifying number, nor did it include an appraiser declaration. In addition, the Form 8283 did not include the donee's signature, its taxpayer identification number, or its statement regarding whether the donor had received any consideration for the contribution.

Taxpayers provided the court with two appraisals, both deficient. The qualified appraisal and other documentation requirements of §170(f)(11) were not satisfied by either of the two appraisals the Allis used to support the contribution and their appraisal summary.

(1) On May 26, 1999, nearly a decade before the contribution of Gladstone, Anthony Sanna, MAI, conducted a market rent survey of the Gladstone apartments for the purposes of HUD's Section 8 housing program. Under the regulations, a qualified appraisal must be made no more than 60 days before the gift and no later than the due date of the return (§1.170A-13(c)(3)(i)).

(2) On April 24, 2008, approximately five months before the contribution of Gladstone, Darvin Jones made an appraisal of the Gladstone apartments as an update to the 1999 Sanna appraisal. The Jones appraisal stated that the purpose of the appraisal was for establishing the properties' values "after the renovation and remodeled [sic] condition." The appraisal elaborated that the "[v]aluation premise [sic] will assume a renovated market position." The Jones appraisal's primary deficiency was that it was not an appraisal of the contributed property but is rather an appraisal of a hypothetical, fully renovated version of the contributed property. Under the charitable contribution statute, the appraised property must be the same property that was donated and that gave rise to the claimed deduction (§170(f)(11)(c)).

IRS argued that taxpayer's corporation really owned contributed property. The IRS argued that the taxpayers were not entitled to a deduction for the contribution of Gladstone because Gladstone did not belong to them. While the court found the record to be "thin" on the issue of who owned Gladstone at the time of the contribution, it didn't matter if the taxpayer's solely owned corporation was the owner since it was an S corporation. Deductions for charitable contributions flow through separately to the shareholders, §1366(a)(1).

Another rule for the contribution of property by the S Corporation. Where the donor is an S corporation, the donor must provide a copy of the appraisal summary to every shareholder who receives an allocation of a charitable contribution deduction with respect to the property described in the appraisal summary (§1.170A-13(c)(4)(iv)(F)). Furthermore, the shareholder must attach a copy of the S corporation's appraisal summary to his tax return (§1.170A-13(c)(4)(iv)(G)).

Taxpayers failed documentation requirement. Since the taxpayers failed to provide proper documentation of the value of their contribution, they were not allowed a charitable deduction.

Planning idea. When a noncash donation exceeds $5,000, review the appraisal for obvious errors as those found by the Court in the Alli case.

Also see. *Harvey and Deanna Evenchik v. Comm.*, TCM 2013-34 where appraisal of wrong asset cost taxpayers their $1 million charity deduction.

Conservation Easement Rules Summarized (CCA 201014056)

Generally, a deduction for a charitable gift of property consisting of less than the donor's entire interest in that property is denied (§170(f)(3)). However, an exception to this general rule exists in the case of a "qualified conservation contribution" (§170(f)(3)(B)(iii)). A contribution is a qualified conservation contribution if the contribution is:

- of a "qualified real property interest,"
- the donee is a "qualified organization," and
- the contribution is "exclusively for conservation purposes" (§170(h)(1)).

Qualified real property interest. "Qualified real property interest" means a "restriction ***(granted in perpetuity)*** on the use which may be made of the real property." Any interest retained by the donor must be subject to legally enforceable restrictions that will prevent uses of the retained interest in the property that are inconsistent with the conservation purposes of the contribution (§1.170A-14(g)(1)).

Exclusively for conservation purposes. "Conservation purpose" includes the preservation of a certified historic structure (see §170(h)(4)(A)(iv)). A contribution is not treated as exclusively for conservation purposes unless the conservation purpose is ***protected in perpetuity*** (§170(h)(5)(A)). In the case of a restriction with respect to the exterior of a building located in a registered historic district (as defined in §47(c)(3)(B)) and certified by the Secretary of the Interior to the IRS as being of historic significance to the district, the qualified real property interest must include a restriction that protects the entire exterior of the building (including the front, sides, rear, and height of the building) and prohibits any change in the exterior that is inconsistent with the historical character of the exterior (§170(h)(4)(B)). The Pension Protection Act of 2006 added requirements for a contribution of a façade easement. Further, the donor must enter into a written agreement with the donee certifying under penalties of perjury that the donee is a qualified organization and has the resources to manage and enforce the restriction and the commitment to do so (§170(h)(4)(B)(ii)). These rules are effective for contributions made after July 25, 2006. Additional requirements apply for contributions made in taxable years beginning after August 17, 2006, including a $500 filing fee (see §170(h)(4)(B)(iii); §170(f)(13)).

> **Preparer note**. 216 conservation/facade easements were docketed into court in 2012. This is an amazing number of cases on one tax issue and indicates a concerted IRS audit effort of which we must be aware.

North Dakota's 99-Year Easement Limit Was Not in Perpetuity—A Requirement for "Exclusivity." (*Patrick J. and Louise M. Wachter v. Comm.*, 142 TC No. 7; Mar. 11, 2014)

Conservation easement denied. A contribution of real property is a qualified conservation contribution if (1) the real property is a "qualified real property interest," (2) the contributee is a "qualified organization," and (3) the contribution is "exclusively for conservation purposes" (§170(h)(1); §1.170A-14(a)). North Dakota state law requires all easements to expire 99 years after they were conveyed, making it unique, because North Dakota is the only state that has a law that provides for a maximum duration that may not be overcome by agreement. The court held that Patrick and Louise Wachter's donations of conservation easements of land to the American Foundation of Wildlife (AFW) were not granted "in perpetuity" for charitable contribution deduction purposes, because North Dakota law limited the duration of real property easements to not more than 99 years (also see §170(h)(2)(C)). The court held that it was "inevitable" that AFW would be divested of its easement interests and the land would revert back to the Wachters.

Conservation Easement Plowed Under by Harsh Tax Court (*Michael S. Mountanos v. Comm.*, TCM 2013-138)

IRS too late to stop original deduction, but attacks contribution carryforward. Michael Mountanos purchased 882 acres of largely undeveloped land in Lake County, California, known as Blue Lakes Ranch (the ranch) for recreational use for his family, such as deer hunting. He conveyed a conservation easement to Golden State Land Conservancy (Golden State), a California nonprofit corporation, in December 2005 and claimed a $4,691,500 charitable contribution deduction on his 2005 tax return. Due to AGI limitations, Mountanos carried forward $3,347,796 of the deduction to future years. While the IRS did not audit Mountanos's 2005 tax return, they did audit his 2006, 2007, and 2008 tax returns and denied the carryforward contribution deduction in those years.

Fair market value must be based on "highest and best use." The value of a conservation easement donation equals the difference between the fair market value of the easement-encumbered property before it is encumbered by the easement and after the easement is established. The fair market value of property must be evaluated in view of the property's highest and best use. The highest and best use of the ranch is the highest and most profitable use for which it is adaptable and needed or likely to be needed in the reasonably near future. However, a property's highest and best use is presumed to be the use to which it is currently being used absent proof to the contrary (*U.S. v. L.E. Cooke Co., Inc.*, 991 F.2d 336, 341 (6th Cir. 1993); *Symington v. Comm.,* 87 TC at 896). Any proposed highest and best use different from a property's current use requires the taxpayer to demonstrate "closeness in time" and "reasonable probability" of the proposed use (*Hilborn v. Commissioner*, 85 TC at 689). Existing zoning, historic preservation and other restrictions at the time of the contribution are considered as well as economic feasibility in evaluating whether a proposed use is reasonably probable and likely in the near future (*Losch v. Comm.,* TCM 1988-230).

Value of vineyard and residential development vs. value of recreational land. Of course, Mountanos claimed that the highest and best use of the ranch before establishing the conservation easement was 287 acres of vineyards and residential development for the remaining acreage. He admitted that the ranch's highest and best use was recreation after the conservation easement was established. The Court agreed with the IRS that Mountanos failed to show that vineyard use was a legally permissible, physically possible, and economically feasible use of the ranch. The court also held that Mountanos had failed to take into account various legal restrictions already in place prohibiting residential development.

No value to easement donation if there is no difference between before and after highest and best use. The Court ruled that there was no difference in the value of the ranch before and after the conservation easement was donated as the highest and best use was the same. As such, the value of the ranch was not diminished as a result of the easement and no charitable deduction was allowed.

Taxpayers lose several recent conservation easement cases, including:

- # *Esgar Corp, Delmar & Patricia Holmes, George and Georgetta Temple v. Comm.*, (CA-10), 12-9009, March 7, 2014; 2014-1 USTC ¶50,207, in which the 10th Circuit, in agreeing with the Tax Court, determined the highest and best use before the contribution was agriculture, not gravel mining.
- # *B.V. And Harriet C. Belk v. Comm.*, USTC 140TC No. 1, Dkt. No. 5437-10, Jan. 28, 2013, where no charitable deduction was allowed because taxpayers retained right to remove property from coverage of the conservation easement. The use restriction was not granted in perpetuity.
- # *Huda T. Scheidelman v. Comm.*, TCM 2013-18, where it was determined that a facade easement did not detract from the value of a townhouse and therefore had no value for contribution purposes.
- # *James M. Pollard v. Comm.*, TCM 2013-38, where no charitable intent existed when a land owner agreed to grant a conservation easement to the county board in exchange for approval of his subdivision request. Agreement was quid pro quo agreement, not charitable.

MISCELLANEOUS ITEMIZED DEDUCTIONS

Continuing Education Expenses Cannot Qualify the Taxpayer for a New Trade

Expenses for education are deductible as business expenses if they:

- # Maintain or improve the worker's skills, or
- # Meet the express requirements of the employer or law,

but only if these expenses are not:

- # Required to meet the minimum education requirements for qualification in the profession, or
- # Qualify the taxpayer for a new trade or business (§1.162-5(a)).

This includes seminar expenses, convention registration, and self-study courses. But, generally the taxpayer must establish by evidence that he or she is in the related trade or business before any expenses, including educational expenses, are deductible (*Link v. Comm.,* 90 TC 460 (1988)).

Deductible educational expenses do not include high school, college courses, and most prelicensing courses such as real estate salespersons and brokers prelicensing courses, EA preparatory courses, CPA review courses, and Bar cram courses as all of these expenses qualify the taxpayer for a new trade or business.

Test: "job performed before and after." Whether an education qualifies a taxpayer for a new trade or business depends upon the tasks and activities he or she was qualified to perform before the education and those that he or she was qualified to perform afterwards. The Court has repeatedly disallowed education expenses where the education qualifies the taxpayer to perform "significantly" different tasks and activities.

Repayment to Medical Center for Cost of Medical Education Not Business Expense (*Tripp and Holley Dargie v U.S*, (CA-6), 2014-1 USTC ¶50,168)

In 1993, Dr. Tripp Dargie enrolled as a student at the University of Tennessee College of Medicine (UT). In 1994, he entered into a Conditional Award Agreement ("the Agreement") with UT and MTMC that provided that MTMC would pay Dr. Dargie's tuition, fees, and other reasonable expenses for attending UT. After graduation and the completion of his residency, Dr. Dargie was required to repay MTMC's grant by either (1) working as a doctor in the medically underserved community of Murfreesboro, Tennessee, for four years or (2) repaying "two times the uncredited amount of all conditional award payments" he received or a lesser amount agreed to by UT. During Dr. Dargie's time in medical school, MTMC paid UT $73,000 on Dr. Dargie's behalf as part of the Agreement. After completing his medical training in 2001, Dr. Dargie decided not to work as a doctor in Murfreesboro. Instead, he chose to practice in Germantown, Tennessee, near Memphis. In 2002, for not fulfilling his service obligation, Dr. Dargie repaid $121,440.02—a sum equal to the $73,000 principal he had received plus interest.

In 2005, Dr. Dargie filed an amended tax return for 2002, claiming he had "inadvertently omitted an ordinary and necessary business expense" on his Schedule C for the full amount of the $121,440 repayment Dr. Dargie had made to UT. He sought to recover a recalculated refund of $30,304 plus interest. Dr. Dargie asserted that the $121,440 amount he sent UT in 2002 was a "damages payment" for breaching the Agreement with MTMC to work in Murfreesboro after his medical training. Consequently,

he argued the payment was an ordinary and necessary business expense permitted under §162(a) because it enabled him to pursue his for-profit medical practice in a different area of the state.
A taxpayer may deduct “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business” (§162(a); see also Treas. Reg. §1.162-1). “For an expense to be deductible under section 162(a), it must meet five basic elements (a) It must be ordinary, (b) it must be necessary, (c) it must be paid or incurred by the taxpayer in the taxable year, (d) there must be a trade or business, and (e) the expense must arise in connection with or proximately result from that trade or business.” The IRS disallowed the deduction under §162 and Dr. Dargie sued, claiming the IRS had erred in its decision. The main point of contention surrounded the last element: whether the expense was claimed in Dr. Dargie’s course of a trade or business or whether it was a personal expense.

Determining factor was why funds were borrowed, not why funds were repaid? The district court granted summary judgment to the IRS, finding that because Dr. Dargie had used the funds to meet the *initial* educational requirements for becoming a physician, the repayment was a personal expense and nondeductible. The circumstances under which Dr. Dargie received the money determined its business or personal characterization, not the circumstances under which he repaid it.

Requirements to Become a Professional Gambler

Professionals deduct losses “above the line” whereas nonprofessionals get stuck with “below-the-line.” If a taxpayer is engaged in a trade or business of gambling, wagering losses, to the extent deductible under §165(d), are deducted in computing adjusted gross income (see §62). On the other hand, if the taxpayer is not in a trade or business of gambling, wagering losses, to the extent deductible under §165(d), are deductible as an itemized deduction in the computation of taxable income.

So what must a gambler do to reach the level of being a professional? For gambling to reach the level of a trade or business activity it must be "pursued full time, in good faith, and with regularity, for the production of income for a livelihood, and * * * not a mere hobby" (*Comm. v. Groetzinger*, 480 U.S. 23, 35 (1987)). The Supreme Court, in *Groetzinger*, held that a taxpayer who spent between 60 and 80 hours per week at dog races qualified as a professional gambler even though the taxpayer received income during the year from interest, dividends, capital gains and salary earned before his job was terminated. Likewise, a taxpayer who spent 35 hours a week at a horse track after losing his job as a salesman and who was seeking a new sales job (where, at the track?) qualified as a professional gambler for purposes of §162 (*Rusnak v. Comm*., TCM 1987-249). A truck driver who averaged 40 hours per week betting on horse races at Yonkers Raceway and who prepared his own detailed “speed figures” qualified as a professional gambler (*James Castagnetta v. Comm*., TCS 2006-24). A slot machine player who used Feng Shui (which helped him determine which days were “lucky days” and which days were not), was initially successful, but stopped gambling after losing his savings, his retirement accounts and found himself $200,000 in debt, was found to have an actual and honest profit objective (“the fact that his approach was unsuccessful does not make it irrational”) [(*Trieu M. Le v. Comm.*, TCS 2010-94]. A professional horse racing gambler was permitted to deduct business expenses (travel, tote sheets, etc.) that created a loss[5] (*Ronald Andrew Mayo and Leslie Archer Mayo v. Comm.*, 136 TC No. 4, Jan. 25, 2011; IRS acquiesced (AOD-2011-06, IRB 2012-23, Dec, 21, 2011)

[5] §165(d) limits the deduction for the wagering losses of persons engaged in the trade or business of gambling. However, §165(d) does not limit deductions for expenses incurred to engage in the trade or business of gambling. Those business expenses are deductible under §162.

Most gamblers are not professional. In most cases, though, the taxpayer is unsuccessful in convincing the court the taxpayer has a bona fide intent of making a profit (e.g., *Jose Calvao v. Comm.*, TCM 2007-57, slot machine player with $132,000 of W-2G's failed to convince court he wasn't gambling for recreational and entertainment purposes; *Pansy V. Panages v. Comm.*, TCS 2005-3, a full-time florist who spent evenings playing the slot machines failed to convince the court that she desired to make a profit gambling; *Thomas L. Pias v. Comm.*, TCS 2005-138, a retired accountant going to casino 2 to 3 times a week as he "was in what I thought was a lucky streak" not considered a professional gambler as the court was not satisfied that he looked to the gambling activity as a source of production of income for his livelihood; *Michael Merkin v. Comr.*, TCM 2008-146, player club points don't help Park Avenue psychiatrist convert gambling activity into trade or business.)

2nd Time around Finds Gambler Lacked Objective to Profit (*Esther K. Chow v. Comm. pro se*, TCM 2014-49)

IRS uses "session-based analysis" to determine slot machine gamblers losses. The 9th Circuit Court of Appeals found that Esther Chow pursued gambling in 2004 and 2005 with a profit objective, allowing net gambling losses of $60,350 and $334, 218 respectively, although adding "this is a close case" (*Chow v. Comm.*, (CA-9) 10-71883; 2012-2 USTC ¶50,585 affirming TCM 2010-48). In 2006, 2007, and 2008, the years at issue in "Chow II," Esther continued to gamble extensively and exclusively on so-called reel slot machines at Morongo Casino Resort and Spa and San Manuel Indian Bingo Casino. Esther attached to each return a Schedule C showing "GAMBLING" as the "Principal business or profession," reporting a $3,090,500 loss in 2006, a $2,500,686 loss in 2007, and a $587,616 loss in 2008. The IRS prepared a so-called "session-based analysis" in which the winnings and losses were calculated on a net basis for each slot machine session in which she played over a period of time and did not take more than a three-hour break.

Five straight years of losses playing the slots indicated an absence of a profit motive. The court pointed out as Esther continued to have substantial gambling losses, this time she failed to establish that she was engaged in her gambling activities with an actual and honest objective of making a profit as she failed to show she "(1) had a business plan for her gambling activities, (2) had a budget for her gambling activities, (3) maintained a separate bank account for her gambling activities, (4) attempted to change her gambling methods in an effort to make them profitable, (5) did any research in slot machine gambling about ways to improve her chances of making a profit from her gambling activities, (6) consulted anyone with expertise in slot machine gambling about ways to improve her chances of making a profit from her gambling activities, or (7) otherwise engaged in her gambling activities in a businesslike manner." In conclusion, the court stated " unlike Chow I, this is not a close case."

CASUALTY AND OTHER LOSSES §165 & 166

The General Rule on Casualty Losses

Casualty loss deduction. Certain losses sustained during the year and not compensated for by insurance or otherwise are deductible (§165(a)). In the case of an individual, this deduction shall be limited to:

- losses incurred in a trade or business;
- losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

except for the casualty losses limitations (e.g., the $100 and 10% limitation rules), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft (§165(c)(3)).

Burden of proof. The taxpayer has the burden of proving that a casualty or theft has actually occurred. In the case of theft, this is usually established by a police report of the investigation showing that breaking and entering actually occurred.

Amount over $100 and over 10% AGI. The amount of the deduction for personal casualty or theft losses is limited to the amount of each loss in excess of $100. The $100 floor on theft losses is applied in the same manner as the $100 floor on personal casualty losses. Also, the amount that may be claimed for all casualty and theft losses for the year is subject to the 10-percent-of-adjusted-gross-income limitation. The amount of the loss to be deducted is measured by the fair market value of the property at the time of the casualty or theft, but not in excess of its cost or other adjusted basis (which also must be proven by the taxpayer), reduced by any recovery received.

Definition of casualty. The loss must arise from an event that is identifiable, damaging to property, sudden, unexpected, and unusual in nature. A casualty loss is limited to the decline in a property's fair market value resulting from a natural disaster that is directly linked to actual physical damage to the subject property and does not include any diminution in fair market value attributable to buyer resistance.

Deductible in year sustained. Generally, a casualty loss is deducted in the year the loss is sustained. A loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. In circumstances where the full extent of the loss is not known, the deduction can be claimed in a subsequent year. However, one's entitlement to a casualty loss deduction cannot be postponed beyond the year in which the full extent of the loss is known.

Promises of restitution. In addition, a casualty or theft loss deduction will be denied where, in the year of discovery, there is a claim for reimbursement and a reasonable prospect of recovery (§1.165-1(d)). Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim.

If the party criminally misappropriating an advance or down payment promises to make restitution and there is a reasonable prospect that he or she will do so, there is no theft loss. Rather, a debtor-creditor relationship is established and any subsequent failure of the party to make restitution may result only in a bad debt (*Douglas County Light and Water Co. v. Comm.,* (CA-9), 2 USTC ¶583))

> **Preparer note.** For example, a manufacturer was not allowed a loss deduction or business expense deduction as reasonable recovery was expected (CCA 200725031).

Promise of partial restitution. If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then the portion of the loss is sustained during the taxable year in which the casualty or other event occurs.

Casualty Loss Deduction Allowed for House Built without Permits (CCA 201346009)

Taxpayer built two houses without obtaining the required building permits. The houses were destroyed in a fire and the taxpayer claimed a casualty loss deduction. The IRS initially argued that the taxpayers were not entitled to a casualty loss deduction because allowing the deduction would "severely and completely frustrate" the State policy of obtaining permits before building a home. The Chief Counsel Advice noted that there was no direct link between the casualty loss deduction that the taxpayer suffered and their failure to obtain permits and ruled that the loss was allowable.

Casualty Loss Denied Due to Taxpayer's Pending Claim against City *(Harry E. Cole v. Comm.*, TCS 2013-34)

Harry and Deborah Cole claimed casualty loss deductions of $2,284 and $18,668 for 2006 and 2008, respectively, related to flooding in their basement.

Lawsuit for flood damage. Taxpayers did not file a claim against their homeowners insurance company for the flood damage to their basement. Instead they filed suit against the City of Baltimore alleging malfunctions related to the city's main water line and asking for reimbursement of the damage. If, in the year of the casualty, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, the loss is not sustained until it can be ascertained with reasonable certainty whether such reimbursement will be received (§1.165-1(d)(2)(i)). Since at the time of trial, the lawsuit was still pending, no casualty loss was allowed for the flood damage in the years claimed.

Return of Gains from Insider Trading Conviction was Deductible under Claim of Right (*Joseph P. Nacchio and Anne M. Esker v. US* (U.S. Court of Federal Claims, 1:12-cv-00020; 12-20T; 2014-1 USTC ¶50,231, (Mar. 12, 2014))

From 1997 to 2001, Joseph Nacchio served as the CEO of Qwest Communications International, Inc. ("Qwest"). In 2001, Mr. Nacchio exercised his stock options and sold shares of Qwest stock on which he reported $44,632,464 in net gain and paid $17,974,832 in taxes on this gain.

Convicted on insider trading and ordered to repay previously reported profits. During a trial in 2007 and a later appeal, Mr. Nacchio was convicted on 19 counts of insider trading relating to Qwest stock sales. He was sentenced to serve 72 months in prison, pay a $19 million fine, and forfeit the net gain he derived from the insider trading.

Taxpayers claimed refunds of taxes paid on monies returned. Nacchio contended that he was entitled to a refund of $17,974,832 under §1341. Section 1341 "provides a special rule favorable to the taxpayer" that "applies when a taxpayer repays money in a current year that belongs to someone else, but was money that [the taxpayer] received and included in gross income in a prior year" (*Culley v. US*, 222 F.3d 1331, 1332 (Fed. Cir. 2000)).

Claim of right requirements. For §1341 to apply, the taxpayer must have subjectively believed he had an unrestricted right to the money in the year it was received based on all the facts available that year (Reg. §1.1341-1(a)(2) (2007)). Further, the taxpayer must be entitled "to a deduction (in excess of $3,000) under another section of the Internal Revenue Code for the loss resulting from" repaying the money (§1341 does not independently create a deduction.) If the taxpayer meets the requirements of §1341, then the taxpayer is entitled to either the equivalent of a refund for income tax paid in the earlier year, or a deduction from income in the year of repayment, whichever is more beneficial to the taxpayer.

IRS argued that a deduction would frustrate public policy. The IRS contended the forfeiture was not deductible under §165 because the deduction "would contravene public policy by 'reducing the sting' of the forfeiture penalty." The IRS further contended that §162(f) prohibited the taxpayers' deduction. Section 162(f) provides, "No deduction shall be allowed under [§162(a) for a business expense] for any fine or similar penalty paid to a government for the violation of any law." The Court disagreed and held that the Nacchio could deduct his forfeiture as a loss under §165 because a forfeiture was not a fine or penalty under §162(f).

Claim of right requires taxpayer to believe he had right to stock proceeds. The Court's ruling that the forfeiture was a §165 loss was not the end of the dispute because the claim of right is a two-part test. Nacchio also had to show that he believed he had an unrestricted right to the trading gain in 2001. Nacchio did not testify on his own behalf and did not plead guilty. His belief as to his claim of right to the forfeited gain was not adjudicated in his criminal trial. Thus, Nacchio was entitled to an almost $18 million refund.

> **Planning idea**. If the taxpayer pleads guilty to a willful act of wrong doing, the Court may decide differently.

The General Rule on Theft Losses

Theft defined. A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. The term "theft" includes, but is not necessarily limited to, larceny, embezzlement, and robbery. Whether a theft has been committed generally depends on the law of the jurisdiction in which the alleged theft occurred, but kidnaping ransom payments, where exacting such payments did not amount to theft, as defined by state law, have been held to be deductible as a theft loss. In addition, criminal intent is a necessary element of the crime of theft and must exist for the event to qualify as a theft loss (*William J. Powers v. Comm.*, 36 TC 1191). For example, no theft loss deduction is allowed if the purported thief has a claim to the property in question because there is no criminal intent.

Theft loss deductible in year of discovery. Theft losses are generally deductible in the year of discovery (§165(e); §1.165-8(a)(2); *Gerstell v. Comm*., 46 T.C. 161 (1966)).

Year of the deduction. §1.165-1(d) allows for a continuous review of the prospects for recovering on a claim for reimbursement, and that a theft loss may be claimed once a taxpayer can "ascertain with reasonable certainty" whether reimbursement will be received.

Unless reasonable prospect of recovery exists. A theft deduction is prohibited if there exists in the year of discovery a claim for reimbursement and a reasonable prospect of recovery. In that situation, a theft loss is not deductible until it is reasonably certain whether reimbursement will actually be received (§1.165-1(d)(3); *Wayno v. Comm*., TCM 1992-53; *Orr v. Comm*., 64 T.C.M. 882 (1992)). Typically, a court will find that a taxpayer has a reasonable prospect of recovery if a taxpayer is engaged in good faith in efforts to recoup a loss, and the chance of recovery is "sufficiently probable to warrant bringing a suit" (§1.165-1(d)(2)(ii); *Estate of Scofield v. Comm*., 59-1 USTC ¶9363, 266 F.2d 154 (6th Cir.)). Stated differently, if at the end of the tax year at issue, a claim for reimbursement with a reasonable prospect of recovery exists, then the portion of the theft loss for which there is a claim for reimbursement will not be considered to be sustained at that time, and it will not be deductible until the tax year in which it is determined with reasonable certainty that such reimbursement will not be obtained. To make things even more difficult, the court, in *Jeppsen, infra* stated "that the fact that a taxpayer *files* a lawsuit may give rise to an inference that the taxpayer has a reasonable probability of recovering his loss." "The fact that a taxpayer, in a given tax year, contemplates filing a suit to recover his losses may be considered in the mix of evaluating whether the taxpayer has a reasonable prospect of recovery. However, like any other subjective factor, this inference should not control the outcome of the case . . . The primary analysis of whether there is a reasonable prospect of recovery on a claim for reimbursement of loss is an objective one." "On the other hand, another court has stated that while the filing of a lawsuit may create the inference of a reasonable prospect of recovery, such an inference does not necessarily arise from the filing of a proof of claim in a bankruptcy case" (*Harrv L. Jeppsen v. IRS*, 128 F.3d at 1414; 97-2 USTC ¶50,878).

Furthermore, if a taxpayer's prospect of recovery was simply unknowable at the end of the tax year at issue, then the taxpayer will not be entitled to take the theft loss deduction that year (*Richard T. Wagner v. U.S.* (2003-1 USTC ¶50,238), 2003 WL 691029 (M.D. Fla. Jan. 21, 2003), aff'd, 90 Fed.Appx. 387 (11 th Cir. 2003)).

Contractor's False Statements and Misuse of Funds in Home Repair Resulted in Theft Loss (*James and Gaetana Urtis v. Comm.*, TCM 2013-60)

Contractor died before finishing $400,000 paid-for remodel job. Construction was running well behind schedule, yet the Urtis's were convinced to make advance payments to Potok. In July 2006 Dariusz Potok suddenly died. After his death, the Urtis's discovered that Potok's subcontractors were not being paid and that he was involved in several other construction projects which were undergoing financial difficulty. The Urtis's deducted a theft loss of $188,070 on their 2007 tax return.

Was loss a theft loss? As used in §165, theft is intended to incorporate any criminal taking of another's property, including the crime of false pretenses. The factual existence of the theft must be established by reference to the law of the jurisdiction where the loss occurred. Although a criminal conviction in a state court may conclusively establish the existence of a theft, the deduction does not depend upon whether the thief is convicted, prosecuted, or even whether the taxpayer chooses to move against him. Moreover, the taxpayer must prove a theft occurred under the relevant state statute only by a preponderance of the evidence. In *Hartley v. Commissioner* (TCM 1977-317), the Court held that the taxpayers were entitled to a theft loss deduction where they showed that a homebuilder had committed the crime of false pretenses when the homebuilder induced the taxpayers to advance the homebuilder cash which was then wrongfully used by the homebuilder for purposes other than construction of their home.

Was a crime committed under State law? Illinois' statute says that "A person commits the offense of home repair fraud when he knowingly enters into an agreement or contract, written or oral, with a person for home repair, and knowingly (1) misrepresents a material fact relating to the terms of the contract or agreement * * *; or (2) uses or employs any deception, false pretense or false promises in order to induce, encourage or solicit such person to enter into any contract or agreement. The Court ruled that Potok knowingly induced taxpayers to enter into the contract by using deception and misrepresentations and, thus, Potok committed the crime of home repair fraud.

Was the theft loss properly claimed in 2007? A theft loss is sustained during the taxable year in which the taxpayer discovers the loss (§165(e); §1.165-1(d)(3), §1.165-8(a)(2)). Generally, the appropriate year for a loss deduction is the year in which the loss is sustained (§165(a)). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no deduction shall be claimed until the taxable year in which it can be ascertained with reasonable certainty whether such reimbursement will be received (§1.165-1(d)(3)). One of the relevant factors in considering whether a reasonable prospect of recovery exists is whether the taxpayer has filed a lawsuit to recoup the loss (*Dawn v. Commissioner* [82-1 USTC ¶9373], 675 F.2d 1077, 1078 (9th Cir. 1982), aff'g TCM 1979-479). Because Mr. and Mrs. Urtis filed a law suit against Onyks Construction's insurance carrier, they had a reasonable prospect of recovery until the lawsuit was lost in 2007. The theft loss was claimed in the proper year.

2013 Form 4684 Modified for Ponzi-type Losses (2013 Form 4684)

Section C of the Form 4684 is new for 2013. Complete Section C if the taxpayer is claiming a tax loss deduction due to a Ponzi-type investment scheme and is using Rev. Proc. 2009-20, as modified by 2011-68.

OTHER TAXES

ADDITIONAL TAX ON NET INVESTMENT INCOME (NII) §1411

***New!* 3.8% Tax Imposed on Net Investment Income (§1411; T.D. 9644 published Nov. 27, 2013; REG-130843-13 published Dec. 2, 2013; REG-130507-11; §1.411-0 through §1.411-10)**

> **Preparer note.** To coordinate the Proposed Regulations (REG-130843-13) with the 2013 Final Regulations (TD 9644), both are effective in 2014. Taxpayers may, however, rely on both for taxable years beginning after December 31, 2012. In addition, regulations that are more restrictive than previously published proposed regulations (REG-130507-11) will apply prospectively only (see §1.1411-1(f)).

Starting in 2013, a 3.8% Net Investment Income (NII) tax is imposed on the lesser of:

an individual's ***net investment income*** (NII) for the tax year, OR
modified adjusted gross income (MAGI) in excess of a floor:
$ $200,000 for single and head of household,
$ $250,000 for joint filers and surviving spouses, or
$ $125,000 for a married taxpayer filing separately (§1411(a)(1) & (b); §1.1411-2(b)(1); §1.1411-2(d)(1)).

These threshold amounts are not adjusted for inflation in the future.

> **Preparer note.** There is no 3.8% NII tax if the taxpayer's MAGI is equal to or less than the $200,000/$250,000/$125,000 threshold amounts. And, of course, there is no 3.8% NII tax for those taxpayers with high salaries and *no* investment income (but the high salaries may be subject to the new .9% Medicare tax on wages starting in 2013).

Example—MAGI under threshold. In 2013, Ron, a single taxpayer, has $190,000 of MAGI including $25,000 from interest, dividends and capital gains. Because Ron's MAGI is less than the $200,000 threshold he is not subject to the NII tax (§1.1411-2(b)(2), Exp).

Salary	$165,000
Net Investment Income (NII)	25,000
Modified AGI	190,000
Threshold (Single)	- 200,000
MAGI less Threshold	0
Lesser of NII or MAGI less Threshold	0
NII Tax Rate	3.8%
NII Tax	$ 0

Example—MAGI over threshold but AGI difference smaller than investment income. In 2014, Ron's MAGI increases to $220,000. His NII tax is limited to $760 as the tax applies to the lesser of $25,000 (net investment income) or $20,000 ($220,000 MAGI minus $200,000 threshold for a single) [§1.411-2(b)(2), Exp].

Salary	$195,000
Net Investment Income (NII)	25,000
MAGI	220,000
Threshold (Single)	- 200,000
MAGI less Threshold	20,000
Lesser of NII or MAGI less Threshold	20,000
NII Tax Rate	3.8%
NII Tax	$ 760

Example—MAGI over threshold but investment income smaller than AGI difference. In 2015, Ron's MAGI increases to $250,000. His $25,000 of net investment income is subject to an NII tax of $950, as the tax applies to the lesser of $25,000 (net investment income) or $50,000 ($250,000 MAGI minus $200,000 threshold for a single).

Salary	$225,000
Net Investment Income (NII)	25,000
MAGI	250,000
Threshold (Single)	- 200,000
MAGI less Threshold	50,000
Lesser of NII or MAGI less Threshold	25,000
NII Tax Rate	3.8%
NII Tax	$ 950

Preparer idea. Combining the top individual income tax rate of 39.6% with the 3.8% NII tax results in a marginal rate of 43.4%. For capital gains, the combined rate is 23.8%. Time to warn our high income clients!

Taxable year of less than twelve months. When an individual's taxable year consists of less than twelve months (a short taxable year, for example when the taxpayer dies in mid-year), the threshold amount is not reduced or prorated (§1.1411-2(d)(2)(I)).

Modified AGI. When calculating the NII tax, modified AGI means an individual's AGI for the tax year increased by otherwise excludable foreign earned income or foreign housing costs under §911 (as reduced by any deduction, exclusions, or credits properly allocable to or chargeable against such foreign earned income) [§1411(d): §1.1411-1(b); §1.1411-2(c)].[6]

Individuals Subject to the 3.8% Additional Tax on Net Investment Income

Individual citizens and residents, but not nonresident aliens. An individual subject to the NII tax is any citizen or resident of the United States.[7] A bona fide resident of a U.S. territory is also subject to the NII tax but only if the individual is required to file a U.S. income tax return under §931 and §935 (Guam, American Samoa, Northern Mariana Islands, §932 (Virgin Islands) and §933 (Puerto Rico). Therefore, the 3.8% NII tax generally does not apply to bona fide residents of "mirror code" jurisdictions because they will not have an income tax liability to the United States if they fully comply with the tax laws of the relevant territory.[8] The 3.8% NII tax does not apply to nonresident aliens unless a §6013(g) election to be treated as a resident is made. Therefore, when a U.S. citizen or resident is married to a nonresident alien individual, the spouses will be treated as married filing separately with a $125,000 threshold amount for the U.S. citizen and the nonresident alien spouse will be exempt from the 3.8% NII tax. If the §6013(g) election is made, the full $250,000 threshold amount for a taxpayer filing a joint return will be available (§1.1411-2(a)(1); §1.1411-2(a)(2)(iv); Preamble.3.B & C).

Dual-resident and dual-status individuals. A dual-resident individual who determines that he or she is a resident of a foreign country for tax purposes pursuant to an income tax treaty between the United States and that foreign country and claims benefits of the treaty as a nonresident of the United States is treated as a nonresident for purposes of §1411. A dual-status individual who is a resident of the United States for part of the year and a nonresident for the other part of the year is subject to §1411 only with respect to the portion of the year during which the individual was a United States resident. However, consistent with the rule for taxable years of less than 12 months, the threshold amount is not reduced or prorated for a dual-status resident (§1.1411-2(d)(2)). A dual-status individual who is a nonresident alien at the beginning of any taxable year but at the close of such taxable year is a United States resident, and who is married to a United States citizen or resident, is allowed to make a joint election with his or her spouse to be treated as a United States resident (§6013(h)). The effect of such an election is to include the combined income of the United States citizen or resident spouse and the dual-status spouse in the NII calculation and subject the income of both spouses to the $250,000 threshold amount for taxpayers filing a joint return (TD 9644, Preamble, 3, A, B, C).

Definition of Net Investment Income

Net investment income is the excess of:

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[6]Additional rules apply to an individual that is a U.S. shareholder of a §957(a) controlled foreign corporation or that is a U.S. person that directly or indirectly owns an interest in a §1297(a) passive foreign investment company (§1.1411-10(e)(1)).

[7]A bankruptcy estate administered under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of an individual debtor shall be treated as a married taxpayer filing a separate return (§1.1411-2(a)(2)(iii); §1.1411-2(d)(1)(ii)).

[8] A mirror code system of taxation means the income tax laws are generally identical to the Code. Three of the five U.S. territories (Guam, the Northern Mariana Islands, and the U.S. Virgin Islands) have a mirror code.

1. The sum of gross income from
   - # interest (and substitute interest payments[9]),
   - # dividends (and substitute dividend payments),
   - # annuities,[10]
   - # royalties,[11] and
   - # rents,
   - # (unless such income is derived in the ordinary course of any trade or business other than from (2) or (3) below);
2. Gross income derived from a §469 passive activity trade or business;[12]
3. Gross income derived from a trade or business of trading in financial instruments or commodities;[13] and
4. Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property[14] other than property held in any trade or business not described in (2) or (3) above.[15] The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.[16]
5. LESS: deductions properly allocable to such gross income or net gain.[17]

Example—Gain from rental activity. In 2013, Jody rents a boat to John for $100,000. Jody's rental activity does not rise to the level of a §162 trade or business and is a passive rental activity. In 2014, Jody sells the boat to John, recognizing a $500,000 taxable gain. Because she isn't in the trade or business of selling boats, Jody must include the $500,000 gain in her net investment income (§1.1411-4(d)(4)(C), Exp. 1).

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[9]A substitute interest payment or a substitute dividend payment made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction is treated as an interest payment or dividend payment and thus as net investment income (Preamble.5.A.ii.b).

[10]Gross income from annuities includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income (see §72(a) and §72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under §72(e)). §72(b), however, excludes from gross income that part of an annuity that bears the same ratio as the investment in the contract bears to the expected return under the contract (determined as of the annuity starting date). Gain or loss from the sale of an annuity would be treated as net investment income. To the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as net investment income (Preamble.5.A.iii).

[11]Gross income from royalties includes amounts received from mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property (Preamble.5.A.iv).

[12]Described at §1.1411-5(a)(1) and -5(b)) [§1.1411-4(a)(1)(ii)].

[13]Financial instruments defined at §1.1411-5(a)(2) and -5(c)(1); commodities defined at §475(e)(2), §1.1411-5(a)(2) and -5(c)(2)) [§1.1411-4(a)(1)(ii)].

[14] When an interest in a partnership or S corporation is disposed of, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account. That net gain or loss is calculated as if all the applicable property were sold at fair market value immediately before the disposition of the interest (§1411(c)(4); §1.1411-7)).

[15]§1411(c)(1) and (2).

[16]§1411(c)(1)(A) & (B); §1.1411-4(a)(1)(iii).

[17]As determined in §1.1411-4(f)) [§1411(c); §1.1411-4(a)(2)].

Example—Partnership dividends and interest pass through to partner as NII dividends and interest. Cindy's share of income from TEN partnership consists of $450,000 of trade or business gross income and $50,000 from dividends and interest. Because Cindy does not materially participate, TEN is a passive activity to her. Therefore, Cindy's $450,000 allocable share of partnership income must be included in NII because it is income from a passive activity trade or business and, of course, the $50,000 of dividend and interest must also be included in NII (§1.1411-5(b)(2), Exp. 5)).

NII includes working capital. Net investment income also includes any income, gain, or loss that is attributable to an investment of working capital. The term working capital generally refers to capital set aside for use in and the future needs of a trade or business (§1411(c)(3); §1.1411-6; Preamble.7).

Example. David owns SportCo, an S corporation that maintains an interest-bearing checking account and an interest-bearing savings account. Any funds in these accounts constitute working capital and any interest income is subject to the 3.8% NII tax (§1.1411-6(b), Exp).

Deductions Allocable to Gross Income from Trades or Businesses

Deductions allocable to income from a trade or business (as described later) are taken into account in determining NII to the extent the deductions have not already been taken into account in determining self-employment income (§1.1411-4(f)(2)(ii); §1.1411-9). A §475 trader with ordinary losses in excess of ordinary gains and net capital gains may claim excess losses as a properly allocable deduction (§1.1411-4(f)(4)).

Net Investment Income Does Not Include:

1. Active income from partnerships and S corporations, including family entities,
2. Any item taken into account in determining self-employment income if SE tax is imposed (§1411(c)(6)),
3. Any distribution from qualified employee benefit plans or arrangements (§1411(c)(5)),
4. Interest on tax-exempt and tax-deferred vehicles such as:
   - # municipal bonds,
   - # tax deferred nonqualified annuities,
   - # life insurance,
   - # veterans' benefits, and
5. Other such items which are otherwise excluded from gross income.

Exclusion and deferral tax provisions also apply to NII tax. Generally, gain that is excluded or not recognized under the general income tax rules (chapter 1) is not recognized for NII purposes (e.g., gain deferred or excluded under §453 (installment method), §1031 (like-kind exchanges), §1033 (involuntary conversions), or §121 (sale of principal residence)). Deduction limitations and disallowance provisions applicable under chapter 1 also apply to the determination of NII (e.g., §163(d) (limitation on investment interest), §265 (expenses and interest relating to tax-exempt income), §465(a)(2) (at risk limitations), §469(b) (passive activity loss limitations), §704(d) (partner loss limitations), §1212(b) (capital loss carryover limitations), or §1366(d)(2) (S corporation shareholder loss limitations) [Preamble, 2]).

Example—$250,000/$500,000 MFJ exclusion on sale of personal residence reduces NII and pre-2013 capital loss carryforward reduces 2013 NII. In 2014, Eddie realized a $200,000 gain on the sale of his principal residence purchased in 2000, a $7,000 long-term capital gain and a $5,000 short-term capital loss carryover from 2013. For income tax *and* NII purposes, Eddie excludes the $200,000 gain realized from the sale of his principal residence (§121) and reduces the $7,000 capital gain by the $5,000 capital loss carryover (§1.1411-4(d)(3)(ii), Exp 3).

Example—§1031 like-kind exchange. In 2013, Joan purchased a piece of undeveloped land for $10,000, intending to hold it for investment. In 2015, Joan exchanged the land plus $5,000 cash for Blackacre land, which has a fair market value of $25,000. While Joan does not have any recognized gain from exchange of her land for Blackacre, her basis in the Blackacre land is $15,000 (her basis of $10,000 in her original land plus additional boot given of $5,000). Joan's 2015 net investment income does not include any realized gain from the exchange. In 2017, Joan sells Blackacre to an unrelated party for $35,000 in cash, recognizing a $20,000 capital gain. Joan's 2017 net investment income includes the $20,000 gain (§1.1411-4(d)(3)(ii), Exp. 4).

Pre-2013 carryforwards allowed in calculating NII. Deductions carried over from a prior year for investment interest (§163(d)), at risk limitations (§465(a)(2)), passive activity losses (§469(b)), losses limited due to lack of partner or S corporation shareholder basis (§704(d); §1366(d)(2)), or capital losses (§1212(b)) and allowed for that taxable year in determining adjusted gross income are also allowed for the determination of NII, whether or not the taxable year from which the deduction is carried precedes the January 1, 2013 effective date of §1411 (Preamble, 2).

Planning for MAGI may involve the installment sales provision.

Example—no installment sale. In 2014, Paul and Susie report $200,000 as wages and $225,000 as gains from the sale of their rental building creating a modified AGI of $425,000. Paul and Susie must pay a 3.8% NII tax on the lesser of their (1) $225,000 of net investment income, or (2) $175,000 of modified AGI in excess of the $250,000 MFJ threshold. Their 3.8% NII tax would be $6,650 ($175,000 x 3.8%).

Salary	$200,000
Net Investment Income (NII)	225,000
MAGI	425,000
Threshold (Married)	- 250,000
MAGI less Threshold	175,000
Lesser of NII or MAGI less Threshold	175,000
NII Tax Rate	3.8%
NII Tax	$ 6,650

Variation—installment sale. Assume the same facts as above except that Vern and Sharon sell their rental building with a 10-year installment contract that results in them annually realizing $22,500 over the life of the contract. Because their AGI stays below $250,000, Vern and Sharon are not required to pay NII tax on the gain.

Salary	$200,000
Net Investment Income (NII)	22,500
MAGI	225,000
Threshold (Married)	- 250,000
MAGI less Threshold	0

Lesser of NII or MAGI less Threshold	0
NII Tax Rate	3.8%
NII Tax	$ 0

Derived in the Ordinary Course of a Trade or Business Exception

Ordinary course of business income not NII unless from either a passive activity or trading in financial instruments or commodities. Gross income is excluded from net investment income if it is derived in the ordinary course of a trade or business unless the trade or business either is a passive activity or involves the trading in financial instruments or commodities.

The ordinary course of a trade or business exception is a two-part test.

1. First, the item must be "derived in" the "ordinary course" of a "trade or business" that is ***not***
   - \# a §469 passive activity with respect to the taxpayer, or
   - \# trading in financial instruments or commodities.
2. Second, if the item is not derived in a passive or trading in financial instruments/commodities trade or business, then such item must also be "derived in" the "ordinary course" of such "trade or business" (§1.1411-4(b); Preamble, 5,B.ii).

§162 trade or business. The term "trade or business," when applied to §1411 and its regulations, is defined within the meaning of §162, the rules of which are well-established by a large body of case law and administrative guidance. §1411 and its related regulations, also does not define the phrase "derived in the ordinary course," relying instead on case law and the §469 regulations (TD 9644; Preamble, 5, B, ii,a & b).

Active trade or business exception determined at individual level. When an individual, estate, or trust ***directly*** owns a trade or business, determining if gross income is excluded from net investment income is made at the individual level (§1.1411-4(b)(1)).

Passive activity determined at owner level. When an individual, estate or trust ***indirectly*** owns a ***passive*** trade or business through one or more passthrough entities (such as a partnership or an S corporation), determining if gross income is excluded from net investment income is made at the owner level (trade or business defined at §1.1411-5(a)(1); §1.1411-4(b)(2)(i)).

> **Exampl—Multiple passthrough entities.** Dave Mendoza owns an interest in UTP, a partnership, which is engaged in a trade or business. UTP owns an interest in LTP, also a partnership, which is not engaged in a trade or business. LTP receives $10,000 in dividends, $5,000 of which is allocated to Dave through UTP. The $5,000 of dividends is not derived in a trade or business because LTP is not engaged in a trade or business. This is true even though UTP is engaged in a trade or business. Accordingly, the ordinary course of a trade or business exception does not apply, and Dave's $5,000 of dividends is net investment income (§1.1411-4(b)(3), Exp 1).

Commodity trader determined at entity level. When an individual, estate or trust ***indirectly*** owns a trade or business ***involved in trading financial instruments or commodities*** through one or more passthrough entities (such as a partnership or an S corporation), determining if gross income is excluded from net investment income is made at the entity level (financial instruments or commodities defined at §1.1411-5(a)(2); §1.1411-4(b)(2)(ii)).

§1411Trade or Business Activities Are Subject to the 3.8% NII Tax (§1411(c)(2); §1.1411-5)

The trades or businesses subject to the NII tax are:

1. §469 passive activities, and
2. trading in financial instruments or commodities (as defined in §475(e)(2)).

> **Example—Application of the rental activity exceptions.** Bonnie, a single individual, is a partner in PRS, LLC, which is engaged in an equipment leasing activity. In 2013, Bonnie's modified AGI is $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity. Bonnie's $300,000 allocable share of income from PRS constitutes gross income from rents with an average period of customer use of the equipment is seven days or less. PRS is treated as a trade or business instead of a rental activity.[18] PRS's activities are not passive to Bonnie as she materially participates. None of Bonnie's income from PRS, including any gain or loss from the sale of the property held in the equipment leasing activity, is subject to NII tax (§1.1411-5(b)(3), Exp 3).

> **Variation—Application of §469 and other gross income.** Assume the same facts as the previous example except that Bonnie does not materially participate PRS's activities. Bonnie's share of PRS's income ($300,000) is NII (§1.1411-4(a)(1)(ii); §1.1411-5(b)(3), Exp 4).

Can Rental Real Estate Income be Derived in the Ordinary Course of a Trade or Business?
Interestingly, the Preamble to the Final Regulations admits that, in certain circumstances, the rental of a single property may require "regular, continuous, and substantial" involvement, resulting in the rental activity being a §162 trade or business. This admission acknowledged the holdings in *Fackler v. Comm.*, 45 BTA 708 (1941), aff'd, 133 F.2d 509 (6th Cir. 1943); *Hazard v. Comm.*, 7 T.C. 372 (1946); and *Lagreide v. Comm.*, 23 T.C. 508 (1954), that the activities of a single property can rise to the level of a trade or business (TD 9644; Preamble, 5,B,ii,a).

Rental of single property unlikely to be an active trade or business. At the same time, the Preamble further noted that the rental of a single piece of property would normally not rise to the level of a trade or business in *every* case as a matter of law (TD 9644; Preamble, 5,B,ii,a). For example, §1.212-1(h) provides that the rental of real property is an example of a for-profit investment activity under §212, not a §162 trade or business (TD 9644, Preamble, 5,B,ii,a).

> **Example—Rental activity**. Adam rents a commercial building to Windstorm, Inc. for $50,000. Adam is not involved in the rental activity on a regular, continuous and substantial basis. Adam's rental activity does not rise to the level of a trade or business and it is a passive activity. Because the $50,000 rental income is not derived from a trade or business, Adam must treat it as gross income from rents subject to NII (per §1.1411-4(a)(1)(I)) [§1.1411-5(b)(3), Exp 1].

[18] per §1.469-1T(e)(3)(ii)

Facts used to determine if a real estate rental activity is a business. Key factual elements that may be relevant when determining when a rental activity rises to the level of a trade or business, include, but are not limited to:

- the type of property (commercial or residential real property, personal property, etc.),
- the number of properties rented,
- the day-to-day involvement of the owner or its agent,
- the type of rental,
- a net lease versus a traditional lease, and
- short-term versus long-term lease (TD 9644, Preamble, 5,B,ii).

The final regulations state that bright-line definitions would be impractical and imprecise due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a §162 trade or business (TD 9644, Preamble, 5,B,ii).

> **Preparer note. Trades or businesses issue Form 1099-MISC, landlords don't.** The IRS will closely scrutinize situations where taxpayers are inconsistent in their treatment of an activity as a trade or business. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of §1411, the IRS will take into account whether the taxpayer complied with any Form 1099 trade or business information reporting requirements to help determine if the activity was a trade or business (§6041; TD 9644, Preamble, 5,B,ii,a)).

A Real Estate Professional's Rental Income May Not be NII

If a taxpayer meets the "50%/750 hours in the real property trades or businesses" requirements to be a real estate professional, the taxpayer's interest in rental real estate is no longer considered a "per se" passive rental activity; instead the rental is treated as if a "trade or business," and the "nonrental" rental real estate activity will not be a passive activity if the taxpayer materially participates in each activity.

Relief provision for real estate professional's rental real estate. Once an individual establishes real estate professional status (e.g., contractors, real estate agents, landlords, property managers, etc.), that status only allows the taxpayer to treat rental real estate activities as nonpassive if the taxpayer satisfies at least one of the seven material participation tests (see §1.469-5T(a)).[19] The Preamble in the Final Regulations notes that not all of the material participation tests provide conclusive evidence that a taxpayer is regularly, continuously, and substantially involved in a rental trade or business, especially when the taxpayer claims material participation by performing substantially all of the work and the total time spent on the activity is under 500 hours in the year (TD 9644, Preamble, 5,E,iii).

> **Example.** Mark is a contractor who works full time in his contracting business. He also owns a single family residence that is rented month to month. Mark is as a real estate professional because he works more than 750 hours per year and more than 50% of his time in his contracting business. Additionally, Mark is the only person that provides services for his residential rental, but he rarely spends more than 20 hours in any given year. While Mark satisfies the material

[19] The term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (§469(c)(7)(C)).

participation test, it is unlikely that his rental real estate rises to the level of a trade or business. Any profit he realizes would likely be included in NII.

Real estate professional safe harbor rules. The final regulations provide a safe harbor test for real estate professionals. If a real estate professional participates in rental real estate activities:

- for more than 500 hours per year, OR
- for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to 2013),

the rental income, and the net gain on sale associated with that activity, will be deemed to be derived in the ordinary course of a trade or business exempt from the NII tax (§1.1411-4(g)(7)(i)(A) & (B); §1411(c)(1)(A)(iii); TD 9644, Preamble, 5,E,iii).

Example. Sharon owns a shopping center. She spends 1,000 hours a year managing the property. Because Sharon spends more than 750 hours a year and spends more than 50% of her personal service hours in a qualified real estate activity, she is a real estate professional (§469(c)(7)). In addition, as she spends more than 500 hours materially participating in her rental activity, any income Sharon receives from the shopping center, including any gain realized upon its eventual sale, is not NII (per §1.1411-4(g)(7)).

Real estate professionals unable to meet the 500 hour safe harbor may still avoid NII tax. Real estate professionals with substantial rental activities *may* derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the safe harbor 500 hour requirement. All facts and circumstances must be analyzed to determine if a real estate rental activity rises to the level of a trade or business (§1.1411-4(g)(7)(iii); T. D. 9644, Preamble, 5,E,iii).

Tax planning idea. The election to treat all rental real estate as a single activity is permitted for NII purposes (under §1.469-9(g)). However, any rental real estate grouped with a trade or business (under §1.469-4(d)(1)(i)(A) or (d)(1)(i)(c)) is treated as a trade or business, not a rental real estate activity (§1.1411-4(g)(7)(ii)(B)).

Self-Charged Rental Income Received from a Taxpayer's Active Trade or Business is Not NII

Special rules for self-charged rental income. Rents received by a landlord from a business in which he or she materially participates must be recharacterized as income *not* from a passive activity (§1.469-2(f)(6)). This is commonly called the "self-rental" recharacterization rules.

Gross income from rent and gain or loss upon sale. If passive rental property rented to a trade or business in which the taxpayer materially participates is (1) recharacterized as nonpassive, or (2) the rental is properly grouped with a nonpassive trade or business activity, then such gross rental income is deemed to be derived in the ordinary course of a trade or business and not subject to the NII tax. In both of these instances, any gain or loss from the sale of assets associated with that rental activity are also treated as held in a nonpassive trade or business (§1.1411-4(g)(6)(i) & (ii); TD 9644, Preamble, 5,E,ii).

Example. Vern rents his office building to his incorporated accounting practice. The rental income is not NII since the rents are for the use of his property used in a business in which he materially participates.

Self-Charged Interest Received from the Taxpayer's Active Trade or Business is Not NII

Gross income from interest that is received by the taxpayer from a nonpassive activity of such taxpayer (self-charged interest), is treated as derived in the ordinary course of a trade or business and is not NII. The amount of interest income that is excluded from NII is limited to the amount that would have been considered passive activity income if the payor was a passive activity of the taxpayer. This special rule does not apply when the interest deduction is taken into account in determining the 2.90% HI tax, that is SE tax above the FICA wage base (§1.1411-4(g)(5); TD 9644, Preamble, 5,E,i; §1401(b)).

"Fresh Start" Regrouping Rules

Regrouping allowed only when §1411 tax first due. Under the §469 passive loss rules, once a taxpayer groups activities, he or she may not regroup those activities in subsequent taxable years unless there was a material change in circumstances or the original grouping was inappropriate (see §1.469-4(e)(1) except as provided in §1.469-4(e)(2) and §1.469-11). The problem is, the NII tax may have unintended consequences from previous grouping decisions. The regulations allow taxpayers to regroup activities ***but only during*** the first taxable year beginning after December 31, 2012, in which:

1. the taxpayer meets the §1411 $200,000/$250,000 MFJ applicable income threshold, AND
2. has net investment income (§1.469-11(b)(3)(iv)).

> **Example—§469 passive loss grouping election also applies to NII calculation.** In 2013, Nate, owned an interest in the NAB partnership. NAB is engaged in two §162 trade or business activities, Adam Software Design and Bright Website Design. For passive loss purposes, Nate properly grouped Adam Software and Bright Website, pursuant to §1.469-4. Nate participated more than 500 hours in Adam Software but only 50 hours for Bright Website during 2013. Because Nate materially participated in the grouped activity, neither Adam Software nor Bright Website are treated as a passive activity for the 3.8% NII tax (§1.1411-5(b)(2), Exp. 2).

Regrouping even allowed on amended return if IRS exam results in §1411 tax. A taxpayer is allowed to regroup on an amended return, but only if the taxpayer was not subject to §1411 on his or her original return (or previously amended return), and if, because of a change to the original return, the taxpayer owed NII tax for that taxable year. This rule applies equally to changes to modified AGI or to NII in an IRS examination (§1.469-11(b)(3)(iv)(C)).

Future voiding of a previous NII regrouping if originally inappropriate. If a taxpayer regroups on an original return (or previously amended return) under these rules, and then subsequently determines that §1411 does not apply to them in that year, such regrouping is void in that year and all subsequent years until a valid regrouping is done. There are two exceptions to such voided elections:

1. The final regulations allow a taxpayer to adopt the voided grouping in a subsequent year without filing an amended return if the taxpayer is subject to §1411 in such year; and
2. If the taxpayer is subject to §1411 in a subsequent year, the taxpayer may file an amended return to regroup in a manner that differs from the previous year's voided regrouping (§1.1411-5(b)).

Net Gain Attributable to the Disposition of Property

In general. As mentioned previously, net investment income (NII) includes net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in any trade or business not either a passive activity or commodity trading. Net gain attributable to the disposition of property is the gain ***recognized***, reduced by §165 deductible losses (including losses attributable to casualty, theft, and abandonment or other worthlessness).[20] Net gain also includes gain or loss attributable to the disposition of property from the investment of working capital (§1411(c)(1) and (2); §1.1411-4(d)(3)(i) & (ii); (§1.1411-6).

Disposition broadly defined. For this purpose, disposition includes a sale, exchange, transfer, cash settlement, conversion, cancellation, termination, lapse, expiration, or other disposition (§1.1411-4(d)(1)).

Capital Loss Reduces Other NII, but Not Below Zero

The calculation of net gain cannot be less than zero. Allowable capital losses are permitted to offset gain from the disposition of assets other than capital assets that are included in NII.[21] As a result, the $3,000 capital loss ($1,500 in the case of an individual filing as married filing separately) is allowed as a properly allocable deduction (TD 9644, Preamble, 5,C,i; §1.1411-4(d)(2); §1.1411-4(f)(4)),

> **Preparer note.** Deductible carryforward losses may be used to offset NII, even if such losses were generated in years prior to 2014.
>
> **Example.** In 2014, Pablo receives wages of $300,000 and earns interest of $5,000. Pablo also realizes a capital loss of $40,000 on the sale of Pfizar Inc. stock and a capital gain of $10,000 on the sale of QuickStop, Inc. stock. Pablo may deduct a capital loss of $3,000 on his 2014 tax return and carry the remaining $27,000 capital loss to future years. Pablo may reduce his 2014 net investment income by the $3,000, the excess of capital losses over capital gains allowed for income tax purposes, leaving only $2,000 of NII (§1.1411-4(d)(3)(ii), Exp. 1)).

2014	Capital Gain	NII	MAGI
Salary			$300,000
Capital Loss (Pfizar, Inc.)	$(40,000)	(10,000)	
Capital Gain (QuickStop, Inc.)	10,000	10,000	
Net Capital Loss	(30,000)	-0-	
Capital Loss Limitation (§1211(b))	3,000	(3,000)	(3,000)
Capital Loss Carryover (§1212(b))	$ (27,000)		
Interest		5,000	5,000
Net Investment Income (NII)		2,000	
MAGI			302,000
Threshold (Single)			(200,000)
MAGI less Threshold			102,000
Lesser of NII or MAGI less Threshold			2,000
NII Tax Rate			3.8%
NII Tax			$ 76

[20] Realized gains or losses on certain sales or exchanges of property are not "recognized," that is, are not included in or deducted from gross income at the time the transactions occurs, such as §1031 like-kind exchanges (see §1.61-6(b)).

[21] Per §1211(b).

Continuation. In 2015, Pablo has a $30,000 capital gain from the sale of YahYou stock. For both regular tax purposes and NII tax purposes, Pablo may reduce the $30,000 gain by the $27,000 capital loss carryover from 2014. Pablo's 2015 net gain for NII purposes is $3,000 (§1.1411-4(d)(3)(ii), Exp. 1)).

2015	Capital Gain	NII	MAGI
Salary			$300,000
Capital Gain (YahYou)	30,000	30,000	
Net Capital Gain	30,000	30,000	
Capital Loss Carryover (§1212(b))	(27,000)	(27,000)	
Net Investment Income (NII)		3,000	3,000
MAGI			303,000
Threshold (Single)			(200,000)
MAGI less Threshold			103,000
Lesser of NII or MAGI less Threshold			3,000
NII Tax Rate			3.8%
NII Tax			$ 114

Capital Loss Carryforwards Reduce Other NII

As previously mentioned, capital losses incurred in a year prior to 2013 (the effective date of §1411) may be taken into account in the computation of NII net gain. An annual adjustment to capital loss carryforwards to prevent capital losses excluded from the NII calculation in the year of recognition from becoming deductible losses in future years has been created (PR §1.1411-4(d)(4)(iii)). The annual adjustment provides a method of identification and an ordering rule that eliminate the need for taxpayers to maintain a separate set of books and records for this item to comply with §1411. However, the rule requires that taxpayers perform the calculation annually, regardless of whether they have a §1411 tax liability in a particular year. For purposes of computing net gain and any properly allocable deduction for excess losses in (if any), the taxpayer's capital loss carryforward from the previous year is reduced by the lesser of (A) the amount of capital loss taken into account in the current year by reason of §1212(b)(1), or (B) the amount of net capital loss excluded from NII in the immediately preceding year. For purposes of (B), the amount of net capital loss excluded from NII in the previous year includes amounts excluded by reason of §1.1411-4(d)(4) (amount of capital losses recognized in the preceding year) plus the amount of the previous year's adjustment required by this rule. The proposed regulations provide a multi-year example to illustrate the application of the rule (see §1.1411-4(d)(4)(iii); REG-130843-13, PR §1.1411-4(d)(4)(iii); Preamble, 3).

NOL can be a Properly Allocable Deduction in Computing NII

Separately calculate NOL and NII NOL. Taxpayers may deduct a portion of an NOL in determining their NII. The portion of the NOL that may be deducted for a taxable year is calculated by first determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of:

1. the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine NII and only properly allocable deductions were taken into account in determining the NOL under the §172(c) and (d) rules, or

2. the amount of the taxpayer's NOL for the loss year.

The allocable portion of the NOL must be calculated for each carryover year. Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a §1411(c)(1)(B) deduction in the taxable year, referred to as the §1411 NOL amount. The sum of the §1411 NOL amounts for each NOL carried to and deducted in the taxable year, referred to as the total §1411 NOL amount, is the amount of the NOL deduction for the taxable year that is properly allocable to NII (§1.1411-4(f)(2)(iv); §1.1411-4(h); Preamble, 5,D,vi).

Exception for Sales of Interests in Partnerships and S Corporations

When calculating NII, net gain does not include gain or loss attributable to property ***held in*** a trade or business other than a passive activity or trading in financial instruments gain or loss (§1.1411-4(d)(4)(i)(A)). The problem is an interest in a partnership or S corporation is not considered trade or business property even though the underlying business could be. The result is that any "net gain" from the sale of an interest in a pass-through entity is included in NII.[22] Congress, however, intended to put an active transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor) [§1.1411-4(d)(4)(i)(B)(1); REG-130843-13; PR §1.1411-7].

Calculate gain or loss on "§1411 property." The IRS solution to this problem requires the pass-through entity to calculate how much of the gain or loss is attributable to net investment assets called "§1411 Property." This definition recognizes that the items of property inside the passthrough entity that constitute §1411 Property might vary among transferors because a transferor may or may not be "passive" (REG-130843-13, Preamble, 9).

Calculation of gain or loss includible in net investment income—Primary Method (PR §1.1411-7)(b)). Therefore, the transferor's NII gain equals the lesser of:

1. the amount of gain the transferor recognizes, or
2. the transferor's allocable share of net gain from a deemed sale of the passthrough entity's §1411 Property (in other words, property which, if sold, would give rise to NII gain or loss). A similar rule is used when a transferor recognizes a loss.

The transferor is to rely on the passive loss valuation requirements (see §1.469-2T(e)(3)), which the materially participating transferor should already be applying under the passive loss limitation rules. Specifically, the transferor's allocable share of gain or loss from a deemed sale of the passthrough entity's §1411 Property equals the sum of the transferor's allocable shares of net gains and net losses (as determined under the §469 principles) from a hypothetical deemed sale of the activities in which the transferor does not materially participate (REG-130843-13, PR §1.1411-7(b); Preamble, 9,C,i).

[22] §1.1411-4(d)(4)(i)(B)(1).

Tax planning. These valuation requirements allow the transferor to compute gain or loss on an activity by activity basis. Because NII applies to all activities in which a transferor does not materially participate (whether held at a gain or a loss), certain provisions under §469 do not apply. For example, the recharacterization rule of §1.469-2T(e)(3)(iii) is intended to recharacterize gains in certain circumstances as not being from a passive activity, and is thus not relevant when calculating NII.

Example—Calculation of gain on sale of partnership interest. Audrey owns 50% of Platinum, LLC in which she has an adjusted basis of $120,000. Audrey sells her interest in Platinum for $200,000 in 2014, recognizing an $80,000 gain under the regular tax rules (called her "chapter 1" gain).[23] Platinum is engaged in three trade or business activities, snowboard construction, ski clothing sales, and ski instruction. Platinum also owns marketable securities. In 2014, Audrey materially participates in the ski instruction but she does not materially participate in the snowboard construction activity or ski clothing sales and the various activities are not grouped (see §1.1411-5(a)(1)). Because Platinum is engaged in at least one trade or business and at least one of those trades or businesses is not passive to her, she must determine the amount of gain or loss from NII. The fair market value and adjusted basis of the gross assets used in Platinum's activities are as follows:

	Adjusted basis	FMV	Gain/ (Loss)	Audrey's share
Snowboard (passive)	$136,000	$ 96,000	$(40,000)	$(20,000)
Ski clothes (passive)	60,000	124,000	64,000	32,000
Ski instruct (active)	40,000	160,000	120,000	60,000
Marketable securities	4,000	20,000	16,000	8,000
Totals	$240,000	$400,000	$160,000	$ 80,000

Analysis. Audrey must determine her portion of gain or loss from the sale of Platinum's §1411 Property. Her allocable share of gain from Platinum's §1411 Property is $20,000 (-$20,000 from the Snowboard activity + $32,000 from the Ski Clothes activity + $8,000 from the marketable securities). Because the $20,000 allocable to Audrey from a deemed sale of Platinum's §1411 Property is less than Audrey's $80,000 total "chapter 1" gain, the $20,000 attributable to the disposition of property will be included in her NII net gain (REG-130843-13; §1.1411-7(b)(2), Exp. 1)

Example. Assume the same facts as the above example, except Audrey materially participates in the ski clothing sales and the ski instruction activities but does not materially participate in the snowboard construction activity. Audrey's allocable share of Platinum's §1411 Property is a loss of $12,000 (-$20,000 from the Snowboard activity + $8,000 from the marketable securities). Even though Audrey sold her interest for a "chapter 1" $80,000 gain, she has no gain ***or loss*** on the attributable to the disposition of NII property because the amount allocable to her from a deemed

[23] Net gain to the extent taken into account in computing taxable income.

sale of Platinum's §1411 Property cannot be less than zero (REG-130843-13; PR §1.1411-7(b)(2), Exp. 2).

Calculation of gain or loss includible in net investment income—Optional Simplified Reporting Method (PR §1.1411-7)(c)). The problem to partners or shareholders is that passthrough entities may not provide a transferor with information that the transferor needs to report NII under the "primary" method (e.g., separate FMV of NII and non-NII assets). To alleviate this problem, certain transferors are allowed to apply an optional simplified method to calculate gain or loss when the amount of gain associated with passive assets owned by the passthrough entity is likely to be relatively small. The optional simplified reporting method limits the information sharing burden on passthrough entities and allows transferors to rely on readily available information to calculate the amount of gain or loss included in NII. The optional simplified method relies on historic distributive share amounts received by the transferor from the passthrough entity to extrapolate a percentage of the assets within the passthrough entity that are passive to the transferor (REG-130843-13, PR §1.1411-7(c); Preamble, 9,C,ii).

> **Example.** If 10% of the income reported on the applicable Schedules K-1 would be included in NII, then the simplified reporting method presumes that 10% of the gain on the disposition of the transferor's interest relates to §1411 Property of the passthrough entity.

Qualifications to use the Optional Simplified Reporting Method. To qualify for the optional simplified reporting method, a transferor must meet either of two requirements.

Alternative 1 = ≤5% NII and ≤$5 million gain: A transferor satisfies the first requirement if:

3. ***NII is 5% or less:*** the sum of the transferor's allocable share during the "§1411 Holding Period" (defined below) of separately stated items of income, gain, loss, and deduction (with any separately stated loss and deduction items included as positive numbers) of a type that the transferor would take into account in calculating NII is 5% or less of the sum of all separately stated items of income, gain, loss, and deduction allocated to the transferor during the §1411 Holding Period, AND
4. ***The total gain is $5 million or less:*** the gain recognized by the transferor from the disposition of the passthrough entity is $5 million or less (including gains from multiple dispositions as part of a plan).

Alternative 2 = Total gain is $250,000 or less: A transferor satisfies the second alternative requirement if the total (chapter 1) gain recognized by the transferor from the disposition of the passthrough entity is $250,000 or less (including gains from multiple dispositions as part of a plan). All dispositions of interests in the passthrough entity that occur during the transferor's taxable year are presumed to be part of a plan (REG-130843-13, PR §1.1411-7(c)(2)(ii); Preamble, 9,C,ii,a).

§1411 Holding Period—3 years. The "§1411 Holding Period" is the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less. Where the transferor acquires its interest from another passthrough entity in a nonrecognition transaction during the year of disposition or the prior two taxable years, the transferor must include in its §1411 Holding Period the period that the previous owner or owners held the interest. Also, where the transferor transferred an interest in a subsidiary passthrough entity to a passthrough entity in a nonrecognition transaction during the year of the disposition or the prior two taxable years, the transferor must include in its §1411 Holding Period that period that it held the interest in the subsidiary passthrough entity (REG-130843, PR §1.1411-7(a)(2)(iii); Preamble,9,C,ii,a).

Example—Optional simplified reporting calculation. Andy owns a one-half interest in PayPlus, a partnership, with an adjusted basis of $1.1 million. In 2014, Andy sells the interest for $2,000,000. Because PayPlus is engaged in at least one trade or business activity and at least one of those trades or businesses is not passive to him (and none of the nonapplicability conditions described in PR §1.1411-7(c)(3) apply), Andy may determine his amount of NII gain or loss using either the primary method or the optional simplified method. The aggregate net income from PayPlus's activities allocable to Andy for 2014, the year of disposition, and the two preceding tax years are as follows:

	Aggregate Income/Loss
Gold coin sales (Nonpassive to Andy)	$1,800,000
Office equipment sales (Passive to Andy)	(10,000)
Marketable securities	20,000
	$1,810,000

Analysis. During Andy's §1411 Holding Period, he was allocated $30,000 of gross items of a type taken into account in the calculation of net investment income ($10,000 of loss from the office equipment sales activity and $20,000 of income from marketable securities). The total amount of Andy's allocated net items during the §1411 Holding Period equals $1,810,000. Thus, less than 5% ($30,000÷1,810,000) of Andy's allocations during the §1411 Holding Period are of a type taken into account in the computation of net investment income, and because Andy's net chapter 1 gain recognized of $2,000,000 is less than $5,000,000, he is qualified to use the optional simplified method (PR §1.1411-7(c)(2)(ii)).

Optional simplified reporting calculation: Andy's percentage of §1411 Property is determined by dividing the $10,000 allocable share of NII income and loss allocated to him by the PayPlus during the §1411 Holding Period ($10,000 loss from the sale of office equipment + $20,000 gain from marketable securities sales), by the $1,810,000 sum of Andy's share of income and loss from all of PayPlus's activities. Andy's NII gain on his disposition of the interest in PayPlus is $4,972 ($900,000 gain on sale of his PayPlus interest multiplied by the fraction 10,000 ÷ 1,810,000) [§1.1411-7((c)(4); §1.1411-4(a)(1)(iii); REG-130843-13; PR §1.1411-7(c)(5), Exp. 1].

When the Optional Simplified Reporting Method cannot be used. Transferor taxpayers are ineligible to use the optional simplified reporting method in situations where the transferor's historical distributive share amounts are less likely to reflect the gain in a passthrough entity's §1411 Property on the date of the transferor's disposition. Examples of such situations include (i) transferors that have held the interest for less than 12 months, (ii) certain contributions and distributions during the §1411 Holding Period, (iii) Passthrough Entities that have significantly modified the composition of their assets, (iv) S corporations that have recently converted from C corporations, and (v) partial dispositions (REG-130843, PR §1.1411-7(c)(3) & (c)(4); Preamble,9,C,ii,b).

Information reporting from the passthrough entity to the seller. The proposed regulations impose information reporting requirements on passthrough entities to ensure that the transferor has sufficient information to comply with the computational requirements, but only to transferors that are ineligible for the optional simplified reporting method (REG-130843, PR §1.1411-7(g)(1); Preamble, 9,G,i).

Information reporting required to be attached to seller's tax return. Partners and S corporation shareholders who transfer their interest must attach a statement to their income tax return for the year of disposition. The statement must include (1) the taxpayer's name and taxpayer identification number, (2) the name and taxpayer identification number of the passthrough entity in which the interest was transferred, (3) the amount of the transferor's gain or loss on the disposition of the interest, and (4) the amount of any adjustment to gain or loss by reason of basis differences for income tax and §1411 purposes. The transferor must also attach a copy of any information provided by the passthrough entity to the transferor relating to the transferor's allocable share of gain or loss from the deemed sale of the entity's §1411 Property (REG-130843, PR §1.1411-7(g)(2); Preamble, 9,G,ii).

Installment sale of interest in partnership or S corporation on or after January 1, 2013. When an interest in a partnership or S corporation is disposed of in a §453 installment sale on or after January 1, 2013, any adjustment to net gain is determined in the year of disposition and shall be taken into account in the same proportion of the total gain as is taken into account under the general §453 installment sale rules (§1.1411-7(b)(1)(i)).

Installment sale of interest in partnership or S corporation before January 1, 2013. When an interest in a partnership or S corporation is disposed of in a §453 installment sale before January 1, 2013, taxpayers may make an irrevocable election for the first taxable year before January 1, 2014 (evidenced by a computational statement (found at §1.1411-7(d)), to have the above post-December 31, 2012 installment sale rules apply (§1.1411-7(b)(ii)). The determination of whether the taxpayer is subject to tax under §1411 is made without regard to the effect of this election. If this election is made, the taxpayer shall calculate the gain or loss adjustment using these installment sales rules and such adjustment shall be taken into account under the "net gain" rules (see §1.1411-4(a)(1)(iii)).

Special Rules for Certain Partnership Payments

Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. Such gain is thus generally treated as NII for purposes of §1411 with the exception for sales of interests by an active partner (see §1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include §707(c) guaranteed payments for services or the use of capital and certain §736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under §1411 may differ from the general rule that net gains on nonbusiness property are included in NII (see §1411(c)(1)(A)(iii); REG-130843-13; PR§1.1411-4(g); Preamble, 2].

Treatment of §707(c) payments. Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore are included as NII (REG-130843-13; PR§1.1411-4(g)(10); Preamble, 2.A).

Treatment of §736(b) payments. Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. The treatment of the payment for purposes of §1411 differs depending on whether the distribution is a §736(b) distribution in exchange for partnership property or a §736(a) distribution in exchange for past services, use of capital, or §736(a) property. §736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for §736(a) property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under §731(a). §736(a)(2) payments for services are not included as NII, and §736(a)(2) payments for the use of capital are included as NII (REG-130843-13; PR§1.1411-4(g)(11); Preamble, 2.B).

Investment Expenses Deductible in Computing Net Investment Income

Only properly allocable deductions may be taken into account in determining net investment income. In order to arrive at NII, gross investment income is reduced by allocable deductions, including:

- investment interest expense,
- investment advisory and brokerage fees,
- expenses related to rental and royalty income,
- tax preparation fees, and
- state and local income taxes properly allocable to items included in net investment income (§1.1411-4(f)(1), (3); Preamble, 5,D,i & ii).

Deductions allocable to both NII and excluded income. In the case of properly allocable deductions allocable to both NII and exclude income, the portion of the deduction properly allocable to NII may be determined using any reasonable method (§1.1411-4(g)(1)).

> **Example.** A reasonable method of allocation includes, but is not limited to, an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) to the amount of the taxpayer's adjusted gross income (§1.1411-4(g)(1)).

There are limits on deductible investment expenses. When calculating NII, only properly allocable investment expenses may be deducted in determining NII and any deduction in excess of gross investment income are not allowed in any other taxable year, except as allowed when determining taxable income (§1.1411-4(f)(1)(i) &(ii); Preamble, 5,D,i).

Tax preparation fees. Properly allocable investment expenses include a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax. This includes expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of tax returns or in connection with any proceedings involved in determining or contesting a tax liability. Any reasonable method may be used to properly allocate these expenses to NII (§1.1411-4(f)(3)(vi); §212(3)).

Deductions allocable to gross income from rents and royalties. Deductions allocable to rents and royalties, §212 expenses for production of income, and §611 depletion, (that therefore constitute net investment income) are taken into account in determining net investment income (§1.1411-4(f)(2)(i)).

Penalty on early withdrawal of savings. Net investment income is reduced by interest forfeited on premature withdrawals from time savings accounts or deposits (§1.1411-4(f)(2)(iii)).

Itemized deductions. Net investment income takes into account the following itemized deductions:

1. ***Investment interest expenses.*** Investment interest that does not exceed the §163(d) net investment income limitation is allowed for NII. Any investment interest not allowed is treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year (§1.1411-4(f)(3)(i)).

   Example—Investment interest expense carryover reduces subsequent NII. In 2014, Amanda pays $4,000 interest on debt used to purchase stock. As Amanda has no investment income, she may not deduct the $4,000 investment interest in 2014. The $4,000 investment interest is carried forward and is treated as investment interest paid by Amanda in 2015 when she has $5,000 of net investment income. For both income tax purposes and determining NII, Amanda's may deduct her $4,000 interest expense carryforward in 2015 (§1.1411-3(i)(A) & (B)).

2. ***Investment expenses.*** Investment expenses must be directly connected with the production of investment income (§163(d)(4)(C); §1.1411-4(f)(3)(ii)).

3. ***State and local, and foreign, income, war profits, and excess profits taxes (per §164(a)(3)).*** The portion of the deduction that is properly allocable to NII (including net gain) may be determined using any reasonable method (§1.1411-4(f)(3)(iii)).

   Example. Keith's investment income included in AGI is $60,000 and his total AGI is $300,000. Keith may deduct 20% of his state and local taxes to arrive at his NII (§1.1411-4(f)(3)(i)(C)).

4. ***Haircuts limit itemized deductions.*** The 2% floor on miscellaneous itemized deductions (§67) and the overall limitation on itemized deductions (§68) are included in determining NII. Net investment expenses are only deductible ***after*** both "haircuts." The 2% floor on miscellaneous itemized deductions (§67) applies before the overall limitation on itemized deductions (§68). The amount of miscellaneous itemized deductions tentatively deductible in determining NII after applying the 2% haircut (§67) but before applying overall limitation on itemized deductions (§68) is a ratio illustrated by the following example (§1.1411-4(f)(7)).

   Example. Barry, an unmarried individual, has adjusted gross income in 2014 as follows:

Wages	$1,600,000
Interest income	400,000
Adjusted gross income	$2,000,000

   Barry also has the expenses which qualify as itemized deductions:

Investment expenses	$ 70,000
Job-related expenses	30,000
Investment interest expense	80,000
State income taxes	120,000

   Barry's investment expenses and job-related expenses are miscellaneous itemized deductions. In addition, Barry's investment interest expense and investment expenses are properly allocable to net investment income. Barry's job-related expenses are not properly allocable to net investment income. Of the $120,000 state income tax expense, $20,000 is properly allocable to NII.[24]

First, calculate the investment expenses after the 2% AGI limit on miscellaneous itemized deductions. Barry's 2% floor under §67 is $40,000 (2% of $2,000,000). Barry's total miscellaneous itemized deductions allowable before the application of the 2% limit is $100,000 ($70,000 in investment expenses plus $30,000 in job-related expenses), and the total miscellaneous deductions allowed after the application of the 2% limit is $60,000 ($100,000 minus $40,000). The amount of the deduction allowed for investment expenses after the application of the 2% limit is:

$$\$70{,}000 \times \$60{,}000 \div \$100{,}000 = \$42{,}000.$$

The amount of the deduction allowed for job-related expenses after the application of the 2% limit is:

$$\$30{,}000 \times \$60{,}000 \div \$100{,}000 = \$18{,}000.$$

Next calculate allocable investment expenses after the 3% itemized deduction phaseout. For 2014, the 3% itemized deduction phaseout under §68 starts at adjusted gross income of $254,200 ($305,050 MFJ). The itemized deduction phaseout disallows $52,374 of Barry's itemized deductions (3% of the excess of $2,000,000 AGI over the $254,200 limitation threshold).

Barry's itemized deductions subject to the itemized deduction phaseout and allowed after the application of the 2% miscellaneous itemized deduction limit, are the following:

Investment expenses	$ 42,000
Job-related expenses	18,000
State income tax	120,000
Deductions subject to	$180,000

Itemized deduction phaseout. Of Barry's itemized deductions that are subject to the AGI phaseout, the amount allowed is $127,626 ($180,000 minus the $52,374). The amount of the investment expense deduction allowed after AGI phase out is determined as follows: $42,000 x $127,626 ÷ $180,000 = $29,779. The amount of the state income tax deduction allowed after the AGI phase out and properly allocable to net investment income is determined as follows: $20,000 x $127,626 ÷ $180,000 = $14,181 (§1.1411-4(f)(7), Exp.).

Investment income	Allocable gross amount	After 2% misc itemized deduction floor	After 3% of AGI phaseout	NII Tax Calculation

[24] In this example, the IRS did not provide their method of allocating the $120,000 state income tax between NII ($20,000) and not-NII ($100,000). Taxpayers are permitted to use ***any*** reasonable method and §1.1411-4(g)(1) illustrates reasonable by allowing the taxpayer to use the ratio of gross investment income to gross income. In this example, that would have resulted in $24,000 being allocated to NII ($120,000 x 400,000/2,000,000 = $24,000). The authors declined to change this example.

Investment interest exp.	$80,000			($80,000)
Investment expense	$70,000	$42,000	$29,779	($29,779)
State income tax	$20,000		$14,181	($14,181)
Net investment income				$276,040
NII Tax @ 3.8%				$10,490

Preparer note. The $80,000 deduction for the investment interest expense is not subject to the 3% itemized deduction phaseout.

Recovery or Refund of a Previously Deducted Item

State tax refunds may reduce properly allocable deductions of state tax payments. In general, the recovery or refund of a previously deducted item shall reduce the total amount of properly allocable deductions in the year of the recovery. For example, if a taxpayer receives a refund of state income taxes from a prior year, such a refund would be included in the taxpayer's gross income with two exceptions:

1. ***First—refund of deduction did not reduce NII as no §1411 liability in prior year.*** Properly allocable deductions are not reduced in the year of the recovery if the amount deducted in the prior year did not reduce the amount of §1411 tax liability.

2. ***Second—recovery of deduction included in subsequent investment gross income or net gain.*** Properly allocable deductions are not reduced in the year of the recovery if the amount deducted in the prior year is included gross investment income (§1411(c)(1)(A); §1.1411-4(g)(2);TD 9644, Preamble,5,D,ii).

   Example. A reimbursement of a deduction from a passive activity trade or business that is gross income for general tax (chapter 1) purposes is included as gross income from a passive activity. Therefore, the recovery is already reflected in the recovery year's NII (§1.1411-4(g)(2)).

Recovery of deduction previously allocated between NII and non-NII. In the case of a recovery of a deduction that was allocated between NII and non-NII (such as taxes), the amount taken into account under this recovery rule is based on the ratio used to allocate the item in the year it was deducted (§1.1411-4(g)(2)).

> **Example.** In 2013 Donna allocates $9,000 (45%) of her state taxes to reduce NII. In 2014 Donna receives a state tax refund of $5,000 from 2013, $2,250 of which is allocable to NII. In 2014 Donna allocates $6,000 (30%) of her state taxes to NII. Donna may only deduct $3,750 ($6,000 - $2,250) of her 2014 state income taxes against NII. The fact that she is only allocating 30% of her state taxes to NII in 2014 is irrelevant.

Refund reduces state tax even if no tax benefit because of AMT. When calculating the amount of the recovery or refund of a previously deducted item, first determine the recovered amount without regard to the tax benefit rule under §111. For example, if a taxpayer receives a refund of state income taxes from a prior year, the refund is included in the taxpayer's gross income. However, if the taxpayer was subject to the alternative minimum tax in the year of the payment, the taxpayer may not have received any tax benefit, and, therefore, some or all of the refund may be excluded from gross income. However, the deductibility of state income taxes for §1411 purposes is independent of the deductibility of the taxes for alternative minimum tax purposes. Therefore, the applicability of the recovery rule in §1.1411-4(g)(2) is determined without regard to whether the recovered amount was excluded from gross income by reason of §111(§1.1411-4(g)(2)(iii)).

> **Example.** In 2014, Rachael allocated $15,000 of state income taxes out of a total of $75,000 to NII. Rachael received no regular tax benefit from her state income tax deduction in 2014 due to the alternative minimum tax (AMT), but she did reduce her §1411 tax. In 2015, Rachael received a refund of $5,000. For regular tax purposes, Rachael excludes the $5,000 refund from gross income in 2015 because of the "no tax benefit " rules of §111. Although the refund is excluded from Rachael's gross income, she must nonetheless reduce 2015's §1411 properly allocable deductions by $1,000 ($5,000 x ($15,000 ÷ $75,000)). Her 2015 state income tax allocation to NII is irrelevant when calculating the required reduction (§1411-4(g)(2)(iv), Exp 2).
>
> **Example variation.** Assume the same facts as the previous example except Rachael's 2014 properly allocable deductions exceeded her NII income by $300. As a result, Rachael was not subject to NII tax in 2014. Rachael will not reduce her 2015 properly allocable deductions for recoveries of amounts to the extent that such deductions did not reduce the NII tax. Therefore, Rachael must reduce 2015's properly allocable deductions by $700 ($1,000 less $300) [§1411-4(g)(2)(iv), Exp 3].

Suspended Passive Losses from a Prior Passive Activity May be Useable

Suspended losses from former passive activities are allowed in calculation of NII (as properly allocable deductions or losses) but only to the extent of the nonpassive income from such former passive activity that is included in NII in that year (§1.1411-4(g)(8)).

Unrecovered Basis in an Annuity is a Properly Allocable Deduction

When an annuitant dies with unrecovered basis in the annuity contract, a deduction for any unrecovered basis is allowed on the decedent's final income tax return for both regular tax and NII tax purposes (§72(b)(3); §1.1411-4(f)(3)(iv)).

Estate Taxes Imposed on IRD that is NII are a Properly Allocable Deduction

NII may include items of Income in Respect of a Decedent (IRD), such as annuities and outstanding installment sale payments, along with a deduction for estate taxes on the IRD items, except to the extent that the deduction is taken into account in determining net gain(§691(a) income; §691(c) expenses; §1.1411-4(f)(3)(v)).[25]

Exception for Self-Employment Income

Net investment income does not include any SE income. Net investment income does not include any item *taken into account* in determining self-employment income. *Taken into account* means income

[25] Within the meaning of §1.1411-4(d)) by reason of §691(c)(4).

included and deductions allowed in determining net earnings from self-employment, even if coming from multiple businesses [§1411(c)(6); §1.1411-9]. However, amounts statutorily exempt in determining net earnings from self-employment, such as real estate rentals, dividends, bond interest, and gain on capital assets, (see §1402(a)(1)-(17) for the entire list) may end up meeting the definition of net investment income (§1.1411-9(a)).

> **Example.** In 2014, Nick's distributive share as general partner in Hydroponic Orchids is $1 million, $300,000 being gain from the sale of a capital asset. Nick pays SE tax on $700,000 and, therefore, that amount is excluded from NII. But, the $300,000 gain on sale of a capital asset does not qualify for the SE income exclusion (per §1402(a)(3)(A)) and may be included in NII if the other §1411 requirements are satisfied (§1.1411-9(c), Exp. 1).

Special rule for traders. Any deductions properly allocable to the trader's business of trading of financial instruments or commodities are taken into account in determining the taxpayer's self-employment income only to the extent that such deductions reduce the taxpayer's aggregated net earnings from self-employment. Any of these trader deductions that exceed the net earnings from self-employment, in the aggregate (if applicable), are allowed in determining the taxpayer's net investment income (§1.1411-9(b)).

> **Example.** Debra makes the §475(f)(2) election as a day trader in commodities. In 2014, she makes $400,000 of gross income and incurs $150,000 of related business expenses. Even though none of her net earnings are subject to SE tax (per §475(f)(1)(D) and 1402(a)(3)(A)), and therefore the exception for self-employment income can't apply, she still is permitted to deduct the $150,000 of expenses from her gross income when calculating NII (§1.1411-9(c), Exp. 3).

Exception for Distributions from Qualified Plans

NII does not include distributions from qualified employee benefit plans or arrangements. NII does not include any distributions from IRAs or from qualified retirement plans, including actual distributions, amounts treated as distributions (such as deemed distributions and Roth IRA conversions) and amounts not treated as a distribution but still must be included in gross income (§1411(c)(5); §1.1411-8(a), -8(b), -8(c)).[26]

> **Preparer note.** Even though distributions from qualified retirement plans and IRAs are not included in NII, they are included in modified AGI, thereby subjecting other investment income to this 3.8% additional tax.

> **Roth IRA planning idea.** Roth IRAs are excluded from both NII and *modified AGI*. What about converting the IRA to a Roth IRA? Prior conventional wisdom held that investors over 50 would not, in their lifetime, get back a decent return on investment on this conversion. Therefore, Roth conversions were considered an estate tax planning device and not an income tax planning device. This conventional wisdom needs to be rethought in light of Roth IRAs' role in minimizing the additional 3.8% tax.

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[26] For example, any income of the trust of a qualified plan or arrangement that is applied to purchase a participant's life insurance coverage (the P.S. 58 costs) is a distribution within the relief provision, and thus is not included in net investment income (1.1411-8(b)(3)).

Example. Eddie and Louise have wages of $200,000, investment income of $50,000 and annual IRA distributions of $65,000. Even though distributions from qualified employee benefit plans are specifically excluded as investment income, these same distributions are taken into account in determining modified AGI. Beginning in 2014, the $65,000 IRA distribution will cause $50,000 of investment income to be subject to the 3.8% additional tax, resulting in an additional tax liability of $1,900. Eddie and Louise *may* be candidates for a Roth conversion as a Roth distribution is not included in either net investment income or modified AGI.

Estimated Taxes are Due on §1411 Taxes

Although many investors may not know until the end of the year if a passthrough investment will generate NII for that year, the NII tax imposed by §1411 will be subject to the estimated tax provisions (§6654; TD 9644, Preamble,1,B).

Foreign Tax Credits Do Not Reduce §1411 Tax

Amounts that are allowed as credits only against income tax, including credits for foreign income taxes, may not be credited against the §1411 tax on NII. This limitation is similar to the limitation applicable to a number of other credits that are allowed only against income, for example, general business credits (see §38). Foreign income, war profits, and excess profits taxes may be allowable as deductions in determining net investment income only if the taxpayer does not choose to take any foreign tax credits under § 901 with respect to the same taxable year. This rule is consistent with the limitation in §275(a)(4) on deductibility of those taxes (§1.1411-1(e); §1.1411-4(f)(3)(iii); TD 9644, Preamble,1,C).

Net Investment Income Tax Reported on Form 8960 (2013 Form 8960; 2013 Form 8960 Instructions)

Form 8960 is used to report net investment income, report related investment expenses that are deductible against NII, and to calculate the NII tax. While the form itself is only one page and seems relatively simple, taxpayers will find the 20 pages of instructions and numerous worksheets much more complex.
FAQs on the Net Investment Income Tax (Q & A on the Net Investment Income Tax, updated Mar. 4, 2014)

IRS posted FAQs to its website. Among the issues addressed are the Modified Adjusted Gross Income (MAGI) thresholds for individuals and basic information about what is and isn't included in the calculation of net investment income (NII).

Certain trusts are not subject to the NII tax. The following trusts are not subject to the NII Tax:

$ Trusts that are exempt from income taxes imposed by Subtitle A of the Internal Revenue Code (e.g., charitable trusts and qualified retirement plan trusts exempt from tax under §501, and Charitable Remainder Trusts exempt from tax under §664).
$ A trust or decedent's estate in which all of the unexpired interests are devoted to one or more of the purposes described in §170(c)(2)(B).
$ Trusts that are classified as "grantor trusts" under §§671-679.
$ Trusts that are not classified as "trusts" for federal income tax purposes (e.g., Real Estate Investment Trusts and Common Trust Funds).
$ Electing Alaska Native Settlement Trusts.

$ Perpetual Care (Cemetery) Trusts.

Ideas to Reduce 3.8% Tax on Net Investment Income

Reduce Investment Income by Maximizing:

1. Tax-exempt and municipal bond income
2. Roth IRA distributions
3. Retirement plan distributions
4. Gains from sales of business property
5. Gifting into Family Limited Partnerships
6. S corporation dividends (if materially participating)

Reduce Investment Income by Minimizing:

1. Rental and other passive activity income
2. Limited partnership income
3. Gains on the sale of passive property
4. Rental income from personal property
5. Income from businesses with no material participation
6. Undistributable taxable income in a trust

HEALTH COVERAGE AND AFFORDABLE INSURANCE EXCHANGES

"Affordable Insurance Exchanges" Established in Each State (CRS Report R42663, Health Insurance Exchanges Under the ACA)

17 State-Based Exchanges, 34 State Partnership Exchanges or Federally-Facilitated Competitive Marketplaces. To allow individuals to buy health insurance through the individual market because they don't have the option to purchase health insurance from their employer or can't because of preexisting conditions or other barriers, who anticipate discontinuing current coverage or who want to explore the availability of more affordable options, states must (and the Federal government will if the states don't), establish State-Based Exchanges, State Partnership Exchanges, or Federally-Facilitated Competitive Marketplaces (referred collectively to as Exchanges). The Exchanges, which opened in every state and the District of Columbia in October 2013, are similar to Nevada's Silver State Health Insurance Exchange, Avenue H, Utah's health exchange and the Arizona's Federally-Facilitated Exchange/Marketplace and are administered by a governmental agency or nonprofit organization. Under the Exchanges, individuals and small businesses with 100 or fewer employees can purchase qualified coverage from a choice of certified health plans rated by the Exchange. In 2017, all businesses, even those with more than 100 employees, may be permitted to purchase coverage. At least two multi-state qualified health plans must be available in each state. The multi-state plans will provide coverage in the individual and small employer markets.

State-Based SHOP. Small businesses seeking coverage for their employees will be able to use the small business health options program (SHOP) exchange (see Avenue H, Utah's Health Exchange). The SHOP exchange is designed to assist qualified small employers and their employees with the purchase of qualified health plans (QHPs) offered in the small group market. Qualified small employers will be able to select one or more QHPs available in the SHOP to offer to their employees, and they will be able to set the amount they will contribute to QHP premiums.

Treasury's statement on Exchanges. "Through Exchanges, insurance companies will compete for business on a level playing field and qualified consumers will have a choice of health plans to fit their needs" (Preamble at Background).

Comment. Insurers may charge higher premium prices based on age, tobacco use, rating area, and/or family size, but not on factors for preexisting conditions, etc. (Preamble at Background).

Among numerous responsibilities, Exchanges will:

- Maintain a website to allow individuals to compare information on health plans;
- Include a calculator on their website to determine the actual cost of coverage after the application of any ***premium assistance tax credit***;
- Certify, for purposes of the individual responsibility penalty, when there has been a failure to maintain ***minimum essential health coverage***, if an individual is either (1) ***exempt from the requirement***, or (2) ***exempt from the penalty***;
- Transfer to Treasury a list of the individuals who are issued a certification of an exemption from the penalty for failing to carry health insurance (including the name and taxpayer identification number of each individual);
- Provide each employer with the name of each of its employees who ceases coverage under a qualified health plan during a plan year (and the effective date of such cessation); and
- Establish Navigator programs (to publicize exchange information).

Other benefits available from the Exchange. The Health Insurance Marketplace will be able to assess whether applicants are eligible for Medicaid or the Children's Health Insurance Program (CHIP).

Exchange health plans. Exchanges will offer several types of health plans, as specified in statute and regulation. Exchange plans will provide a comprehensive set of covered benefits (i.e., the essential health benefits). While most of these comprehensive plans will be available to any individual or employer who is qualified to enroll in exchanges (such as multi-state QHPs and CO-OP QHPs), some plans will be available only to specific subpopulations (child-only QHPs and catastrophic QHPs) [CRS Report R42663, Health Insurance Exchanges Under the ACA].

Qualified health plans. In general, exchanges will offer comprehensive coverage that meets the standards to be certified as "qualified health plans" (QHPs), provided it meets requirements related to marketing, choice of providers, plan networks, and other features, or is recognized by each exchange through which such plan is offered. In addition, all QHPs are required to comply with benefit, cost-sharing, and generosity components of the essential health benefits package. An issuer of QHPs must be licensed and in good standing with each state in which it offers coverage; must offer at least one QHP each providing silver and gold levels of coverage; and must comply with regulations applicable to exchanges. An issuer may offer QHPs outside of exchanges as well as inside, but the premiums would have to be the same, even if the QHP is sold through an insurance agent (CRS Report R42663, Health Insurance Exchanges Under the ACA).

Levels of Plan Coverage

Four levels of essential benefits coverage. The Exchanges will offer four levels of essential benefits coverage to individual participants. At the lowest level (bronze), plans must provide benefits that are actuarially equivalent to 60% of the full actuarial value of the benefits provided under the plan, with the percentages increasing at the higher levels as follows:

$	Bronze level plans:	60%	of the full actuarial value of benefits provided under the plan
$	Silver level plans:	70%	of the full actuarial value of benefits provided under the plan
$	Gold level plans:	80%	of the full actuarial value of benefits provided under the plan
$	Platinum level plans:	90%	of the full actuarial value of benefits provided under the plan

Adequate coverage, a.k.a. minimum value. A plan fails to provide minimum value if the plan's share of the total allowed costs of benefits provided under the plan is less than 60% of those costs. A plan is considered to provide adequate coverage (also called minimum value) if the plan's actuarial value (i.e., share of the total allowed costs that the plan is expected to cover) is at least 60%. If the coverage offered by a large employer fails to provide minimum value, an employee may be eligible to receive a premium tax credit from a state Exchange.

Actuarial value (AV). Health plans that provide the essential health benefits package must tailor cost-sharing to meet one of these four levels of generosity, based on actuarial value. Actuarial value (AV) is a summary measure of a plan's generosity, expressed as the percentage of medical expenses estimated to be paid by the issuer for a standard population and set of allowed charges. In other words, AV reflects the relative share of cost-sharing that may be imposed. On average, the lower the AV, the greater the cost-sharing. While actuarial value (AV) is a useful measure, it is only one component that addresses the value of any given benefit package. AV, by itself, does not address other important features of coverage, such as total (dollar) value, network adequacy, and premiums. While the term actuarial value may imply a high level of precision, actuarial analysis is inherently an estimation process and hence is somewhat inexact. Actuarial value estimates will vary by the data sources, projection methods, and assumptions used, and there may be a reasonable range of appropriate methods and assumptions used to develop these estimates (CRS Report R42663, Health Insurance Exchanges Under the ACA).

IRS's minimum value calculator determines actuarially if employer's coverage offers minimum value (The Center for Consumer Information & Insurance Oversight (CCIIO)). A minimum value calculator will be made available by the IRS, which works in a similar fashion to the CCIIO Actuarial Value Calculator that HHS is making available. The percentage of the total allowed cost of benefits will be determined using one of the main methodologies described in HHS's proposed regulations and Notice 2012-31. Employers can input certain information about the plan, such as deductibles and co-pays, into the calculator and get a determination as to whether the plan provides minimum value (using CCIIO's Minimum Value Calculator) by covering at least 60% of the total allowed cost of benefits that are expected to be incurred under the plan (Q&A #12 on Employer shared Responsibility Provisions under the ACA; REG-138006-12, Explanation of Provisions Preamble, III(B)).

> **Planning idea.** The actuarial value calculation for determining minimum value includes the employer contributions to health savings accounts (HSAs) and health reimbursement accounts (HRAs) that are part of a high deductible health plan (HDHP).

Congress isn't exempt from the ACA. Prior to 2014, lawmakers received insurance through the Federal Employees Health Benefits Plan, just like other federal employees. In 2009, a proposal by Sen. Chuck Grassley (R-Iowa) requiring members of Congress, along with their staff, to be out of the federal system and into exchanges was added to the Affordable Care Act.[27] The problem was the ACA never created a mechanism to pay for the coverage. The Obama administration announced that lawmakers and their staffs can keep their employer contributions and apply that money towards the cost of whatever insurance they buy in the exchanges.

Child-Only Qualified Health Plans

ACA requires an issuer that offers a QHP through an exchange also to offer that plan as a "child-only plan." Child-only plans will provide QHP coverage for individuals who are less than 21 years of age. The final regulation on exchanges stated that a child-only plan must be provided at the same level of coverage (bronze, silver, gold, or platinum) as a qualified health plan (77 Federal Register , 18469, March 27, 2012; CRS Report R42663, Health Insurance Exchanges Under the ACA).

Catastrophic Plan

Issuers may offer catastrophic plans in the exchanges, which will have actuarial values less than what is required to meet any of the levels of plan generosity for qualified health plans (described above). These plans are expected to have lower premiums, because they will have less generous coverage and higher cost-sharing. Catastrophic plans must:

$ be available ***only*** to individuals under 30 years of age, or individuals exempt from the individual mandate, because they do not have access to affordable coverage or experienced a hardship;
$ include coverage for "essential health benefits";
$ include coverage for at least three primary care visits;
$ have a deductible equal to existing cost-sharing limits relating to certain high deductible health plans (the deductible will not apply to "preventive health services"); and
$ be offered only through the individual health insurance market.

Exception. For plan years beginning before January 1, 2014, a grandfathered health plan (as defined under §1251 of ACA) may exclude from coverage an adult child who has not attained age 27 if the adult child is eligible to enroll in an employer-sponsored health plan.

INDIVIDUAL MANDATE UNDER ACA

Individuals Required to Maintain Minimum Health Coverage or Pay a Penalty (§5000A; REG-148500-12, §1.5000A-1; Questions and Answers on the Individual Shared Responsibility Provision; CRS Report R41331, Individual Mandate and Related Information Requirements under ACA - Effective 2014

Individuals are required to have minimum health insurance for at least one day in a month, qualify for an exemption, or make a "shared responsibility payment" when filing their federal tax return. Beginning in January 2014, nonexempt individuals must either maintain ***"minimum essential health coverage"*** for themselves and their ***dependents*** for each month during the taxable year or pay a ***"shared***

[27] The ACA law: "The only health plans that the Federal Government may make available to Members of Congress and congressional staff with respect to their service as a Member of Congress or congressional staff shall be health plans that are—(I) created under this Act (or an amendment made by this Act); or (II) offered through an Exchange established under this Act (or an amendment made by this Act)."

responsibility payment" (penalty). An individual has minimum essential health coverage for a month in which the individual is enrolled in and entitled to receive benefits under a program or plan identified as minimum essential health coverage for at least one day in the month. Married individuals who file a joint tax return are jointly liable for any shared responsibility payment (Preamble, 1,b,ii).

Children and senior citizens must have coverage. The individual shared responsibility provision applies to individuals of all ages, including children and senior citizens. Each child must have minimum essential coverage or qualify for an exemption for each month in the calendar year. The person claiming a child or another individual as a dependent for Federal income tax purposes is responsible for making the payment if the dependent does not have coverage or an exemption (§1.5000A-1(a) & (b));§1.5000A-1(c)(1), (2), & (3); Q&A #8 & 9).

> **Warning.** Individuals who could, but do not, timely enroll in an eligible employer-sponsored plan are not eligible for any credit from the Exchange.

> **Preparer note.** Most lower-income individuals, along with some middle-class families, will receive government help to pay for health insurance purchased at state Exchanges.

Individuals Exempt From Having Health Coverage (REG-148500-12; §1.5000A-3)

Certain individuals are exempt from the requirement to maintain minimum health coverage. Individuals are exempt from the health coverage requirement, and, therefore, treated as having minimum essential coverage,[28] for months they are:

1. ***Members of recognized religious sects*** (§1.5000A-3(a); Q&A #5);
2. ***Member of health care sharing ministry*** (§1.5000A-3(b));
3. ***Exempt noncitizens*** (§1.5000A-3(c)); or
4. ***Incarcerated individuals*** (§1.5000A-3(d); Preamble, 3,d).

Other individuals are exempt from the penalty even if not exempt from the requirement to maintain minimum essential health coverage. The following applicable individuals will be exempt from the penalty for failure to maintain minimum essential health coverage (and, therefore, treated as having minimum essential coverage):[29]

1. ***Individuals who cannot afford coverage because premiums exceed 8% of household income.*** No penalty will be imposed for a month in which an individual lacks "affordable" coverage, that is, the individual's required contribution[30] (determined on an annual basis) for minimum essential health coverage for the month exceeds 8% (the required contribution percentage) of the

[28] §1.5000A-3(j)(2)(ii)).

[29] §1.5000A-3(j)(2)(ii)).

[30] The amount of required contribution depends on where the individual can get insurance. For example if the individual is eligible to purchase minimum essential health coverage through an employer sponsored plan, the annual premium is based on the self-only coverage. Otherwise the required contribution is the annual bronze plan premium reduced by any premium assistance credit.

individual's household income.[31] When determining household income, a taxpayer's family includes all individuals for whom the taxpayer properly claims a personal exemption deduction under §151 for the taxable year.[32][§1.5000A-3(e)(1) & (2); Preamble, Exempt Individuals].

2. ***Household income below filing threshold.*** Taxpayers with household income below the income tax filing threshold are exempt from the penalty. For 2014, the filing threshold is $10,150 for a single person or a married person filing separately, and is $20,300 for married filing jointly, but the requirement to file a federal tax return depends on filing status, age, and types and amounts of income (§5000A(e)(2); §6012(a)(1); IR-2013-4; Q&A #22).
3. ***Native Americans.*** All members of Federally recognized Indian tribes are exempt from the penalty. The value of any qualified Indian tribe health care benefits is excluded from gross income for benefits and coverage provided after March 23, 2010.
4. ***Hardships.*** The Exchange will issue a hardship exemption certificate when the individual certifies he or she has suffered a hardship making it impossible to obtain minimum essential health coverage. Several different types of hardship exemptions are described in the regulations; two of the types will be provided exclusively through the tax filing process, not through exchanges (§1.5000A-3(h); 78 Federal Register 39494, July 1, 2013);
5. ***Short lapses of coverage (less than 3 months) during year.*** No penalty is assessed for individuals who do not maintain health insurance for any month if the last day of that month occurs during a period in which the individual was not covered by minimum essential coverage for a continuous period of less than three months (§1.5000A-3(j));
6. ***Individuals outside of U.S.*** Individuals residing outside the United States are exempt from the penalty because they are treated as being covered by acceptable coverage during any month 1) they are bona fide residents of any U.S. possession, or 2) that occurs during the residency period that qualifies them for the foreign earned income exclusion.[33]
7. ***Dependents.*** If an individual is a dependent of another taxpayer, the other taxpayer is liable for any penalty payment with respect to the individual; dependents are effectively exempt from paying the penalty (§1.5000A-3(a)-(h)).

Exemption certificates issued by an Exchange. In order to claim a religious exemption and some types of hardship exemptions, an individual must obtain an exemption certification issued by the health insurance exchange serving the area in which the individual resides. All other exemptions may be certified by an exchange or may be claimed on the filer's federal income tax return. Regulations provide that most exemptions be applicable retrospectively (with an exception for a specific hardship definition) and be recertified annually; only the religious and Indian tribe exemptions are eligible for prospective or retrospective applicability and continuous certification. Exchanges may only certify exemptions for applications made within the calendar year for which the exemption is being sought. Individuals seeking to claim exemptions after December 31st of the relevant year must do so on their federal tax return. If an individual receives an exemption certification from an Exchange, the taxpayer must attach the certificate

[31] The definition of "household income" is ***increased*** by any portion of the required contribution made through a salary reduction agreement excluded from the individual's gross income (e.g., health insurance premiums paid from a cafeteria plan) [§1.5000A-3(3)(1)].

[32]See also §1.36B-1(d).

[33] U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs (§911). In order to qualify for these exclusions, a U.S. citizen must be either (1) a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year, or (2) present overseas for 330 days out of any 12 consecutive month period. In addition, the taxpayer must have his or her tax home in a foreign country.

to the taxpayer's Federal tax return. Alternatively, a taxpayer may claim any of these exemptions on the taxpayer's Federal tax return for the taxable year (§1.5000A-3(a)(2); Preamble, 3,b; Q&A #20; 78 Federal Register 39494, July 1, 2013).

Individual mandate exemptions.

Exemption	Eligibility Certification	Applicability	Recertification
Religious conscience	Exchange only	Prospective or retrospective	Continuous
Hardship	Exchange or tax filing	Retrospective	Annual
Health care sharing ministry membership	Exchange or tax filing	Retrospective	Annual
Indian tribe membership	Exchange or tax filing	Prospective or retrospective	Continuous
Incarceration	Exchange or tax filing	Retrospective	Annual
Affordability	Tax filing only	Retrospective	Annual
Unlawful resident	Tax filing only	Retrospective	Annual
Coverage gap	Tax filing only	Retrospective	Annual
Filing threshold	Tax filing only	Retrospective	Annual

Source: 45 CFR Parts 155 and 156 and 26 CFR Part 1.

Lack of affordability exemption. The income-based exemptions for individuals who lack affordable coverage or have household income below the applicable income tax return filing threshold and the exemption for short coverage gaps may be claimed only on the individual's Federal income tax return for the applicable year. Thus, an individual claiming the affordability exemption will do so on the Federal income tax return that reports the individual's income establishing qualification for the exemption (Preamble,3,h).

> **Planning idea.** Individuals claiming the short coverage gap, unlawful residence, filing threshold, or affordability exemptions may only do so on their federal income tax return.

Household income below "applicable filing threshold." An individual is exempt for the month if the individual's household income for the taxable year is less than the amount of gross income that triggers the individual's requirement to file a Federal income tax return (Preamble,3,f).

An interesting household income vs. filing threshold IRS Q&A. "If my income is so low that I am not required to file a Federal income tax return, do I need to do anything special to claim an exemption from the individual shared responsibility provision? **No.** Individuals who are not required to file a tax return for a year are automatically exempt from owing a shared responsibility payment for that year and do not need to take any further action to secure an exemption" (Q&A #22).

Individual with short lapses of coverage (first gap is less than three full calendar months) during year. An individual is exempt from the requirement to have minimum essential health coverage if the coverage gap is a continuous period of less than three months. Continuous period is determined by months; therefore, if the individual has minimum essential coverage for one day in a calendar month, the month is not included in the continuous period. If a calendar year includes more than one short coverage gap, the waiver of the penalty applies only to the *first* gap in coverage; it does not apply to any subsequent gaps of three months or less during the year. If an individual exceeds the three-month maximum, the penalty applies for the full period, including the gap (§1.5000A-3(j)(2); Preamble, 3,g).

If an individual does not have minimum essential coverage for a continuous period that begins in one taxable year and ends in the next, the months in the second taxable year included in the continuous period are disregarded. When applying this rule to the second taxable year, the months in the first taxable year included in the continuous period are taken into account. Accordingly, if a calendar year taxpayer has a continuous period of three months or longer that starts in November or December of one taxable year and ends in the next taxable year, then any ensuing months of the second taxable year that are included in the period are ineligible for the short coverage gap exemption (§1.5000A-3(j)(3); Preamble,3,g,i).

To provide taxpayers with certainty when filing their Federal income tax returns, an individual who lacks minimum essential coverage for a period no longer than the last two months of a taxable year will be deemed to have a short coverage gap exemption for those months if the short coverage gap is the first to occur in that taxable year, without regard to whether the individual is covered during the first months of the following taxable year (Preamble,3,g,i).

Individual who *may be claimed* as a dependent. An individual is a dependent of a taxpayer if the individual satisfies the §152 definition of dependent, regardless of whether the taxpayer claims the individual as a dependent. (§1.5000A-1(c)(2)(i)).

Adopted dependents or foster dependent during the taxable year. If a taxpayer adopts a nonexempt individual, the taxpayer is liable only for the full months that follow the month in which the adoption or acceptance occurs. If a taxpayer places an individual for adoption, the taxpayer is liable only for the full months that precedes the month in which the adoption or foster care placement occurs (§1.5000A-1(c)(2)(ii)).

Minimum Essential Coverage—Requirements to be Included in the Essential Health Benefits Package

ACA does not explicitly list the benefits that comprise essential health benefits (EHBs). Instead, the law identifies 10 broad benefit categories which must be included in EHBs, at a minimum:

$ Ambulatory patient services
$ Emergency services
$ Hospitalization
$ Maternity and newborn care
$ Mental health and substance use disorder services
$ Prescription drugs
$ Rehabilitative services and devices
$ Laboratory services

$ Preventive and wellness services (including chronic disease management)
$ Pediatric services (including oral and vision care)

Additional benefits may be provided in the health plans in addition to those included in the essential health benefits package.

Elements of an essential health benefit package. The HHS Secretary must take into account the following factors when determining the specific elements of the essential health benefits package:

Balance of benefits—There must be an appropriate balance among the essential benefits.
No discriminatory design decisions—The package, including coverage decisions or reimbursement rates, may not discriminate against individuals because of his or her age, disability or expected length of life.
Consider diverse health needs—The health needs of women, children, persons with disabilities, and other diverse segments of the population should be taken into account.
Emergency room services—Emergency room services coverage must be provided even when the service provider does not have a contractual relationship with the plan. But, the cost-sharing for such out-of-network service may not exceed in-network costs for those services.
Stand-alone dental benefits—If an Exchange offers stand-alone dental plan, other Exchange health plans need not provide for the pediatric dental care otherwise required as an essential benefit.
Denial of benefits—Individuals may not be denied essential health benefits based on the individual's age, life expectancy, current or predicted disability, degree of medical dependency, or quality of life.

Minimum essential coverage does not include specialized coverage, such as dental-only coverage. Minimum essential coverage does not include specialized coverage, such as coverage only for vision care or dental care, workers' compensation, disability, automobile liability insurance, coverage only for a specific disease or condition, or coverage for employer-provided on-site medical clinics. The Health Insurance Portability and Accountability Act (HIPAA) specifies which medical care benefits are secondary or incidental to other insurance benefits. Other HIPAA excepted benefits that do not constitute minimum essential coverage if offered under a separate policy, certificate, or contract of insurance include long-term care, limited scope dental and vision benefits, coverage for a disease or specified illness, hospital indemnity or other fixed indemnity insurance or Medicare supplemental health insurance (also known as Medigap or MedSupp Insurance) and TRICARE supplemental policies (Preamble, Minimum Essential Coverage; Q&A #4).

Proposed and temporary preventive health services regulations issued (T.D. 9493, NPRM REG-120391-10). Proposed, temporary, and interim final regulations implementing the rules for group health plans and health insurance coverage in the group and individual markets regarding preventive health services have been issued. Group health plan and a health insurance issuer offering group or individual health insurance coverage will be required to provide benefits without imposing cost-sharing with respect to the defined preventive health services.

Minimum Essential Health Coverage (§5000A(f); REG-148500-12; §1.5000A-2)

Minimum essential health coverage includes:

Government sponsored health programs, such as Medicare, Medicaid,[34] Children's Health Insurance Program (CHIP), TRICARE, coverage for members of the U.S. military, certain types of Veterans' health care (including CHAMPVA and certain children of Vietnam and Korean Vets), RICARE, health care for Peace Corps volunteers and DOD nonappropriated Fund Health Benefits (§1.5000A-2(b); Q&A #4);
Eligible employer-sponsored plans, such as group health plans (whether an insured or self-insured group health plan) or group health insurance coverage offered through the small or large group market[35] within a state, governmental plans, church plans, and grandfathered plans. Coverage provided by an employer to a former employee, including coverage under COBRA and retiree health coverage, qualifies as coverage under an eligible employer-sponsored plan (§1.5000A-2(c); Preamble, 2,b,ii).
Plans in the individual (i.e., nongroup) market, and plans offered by an Exchange (§1.5000A-2(d));
Grandfathered group health plans (i.e., coverage in effect on March 23, 2010) [§1.5000A-2(e)];
Self-funded student health plans;
Refugee Medical Assistance supported by the Administration for Children and Families;
State health benefits risk pool.

Individuals can keep their old health plans. Individuals may keep their individual and group health plans that were in effect on March 23, 2010. In addition, these plans are exempt from many of the individual and group market reforms that take effect in 2014.

Individuals Eligible for Coverage under Employer Plans

Employer coverage determines if *eligible* employee's coverage is affordable or not. If an employee, or relative of the employee,[36] is *eligible* for minimum essential health coverage under an eligible employer-sponsored plan, only the cost of employer's plan determines if the individual lacks affordable coverage (Preamble, 3,e,i,A).

> **Planning idea.** Each employed spouse's eligibility for the health credit will be determined by testing their own employer's health plan for affordability.

An employee eligible for coverage under an eligible employer-sponsored plan cannot also claim to be a "related" individual of an employed spouse or a parent. If two or more members of a family are employed and their respective employers offer self-only and family coverage under eligible employer-

[34]Other than optional Social Security Act (§1902) coverage, including family planning services, tuberculosis-related services, pregnancy-related services, and medical emergency services (§1903). Accordingly, limited benefit programs under title XIX of the Social Security Act are not minimum essential coverage and comprehensive health care programs under chapter 17 or 18 of title 38, United States Code, are minimum essential coverage (Preamble, 2,a).

[35] The large group market consist of health plans maintained by large employers (generally those with more than 100 employees). The small group market consist of health plans maintained by small employers (generally those with no more than 100 employees; however, each state can elect to reduce this 100-employee threshold to 50 employees).

[36] A related person is an individual who is eligible for coverage under an eligible employer-sponsored plan because of a relationship to an employee ***and*** for whom a §151 personal exemption deduction is claimed on the employee's Federal tax return (§1.5000A-3(e)(2)(ii)(B); §1.5000A-3(e)(3)(i)(A)).

sponsored plans, each employed individual determines the affordability of coverage using the premium for the self-only coverage offered by the individual's employer. Neither individual may determine the affordability of coverage using the premium for family coverage offered by the other individual's employer (Preamble, 3,e,i,A).

> **Example.** An employee's spouse is treated as a related individual if the spouse files a joint return with the employee and is eligible for employer-sponsored coverage ***only*** under the plan offered to the employee.

> **Planning idea.** In these cases, each employed individual's self-only coverage may be treated as affordable, even though the aggregate cost of covering all employed individuals may exceed 8% of the family's household income.

Some individuals who are claimed as dependents by a taxpayer may not be eligible for coverage under the taxpayer's eligible employer-sponsored plan. The affordability of coverage for these individuals is determined in the manner that applies to them individually (Preamble,3,e,i,C).

> **Example.** If Jackson is not allowed to enroll Nieva, a niece who is Jackson's dependent, in his eligible employer-sponsored plan, the required contribution for Nieva is not determined by reference to the cost of coverage under the plan. Instead, unless Nieva is eligible for coverage under another eligible employer-sponsored plan, her required contribution is determined under the rules applicable to individuals eligible only to purchase coverage in the individual market.

Employee includes a retired or former employee. An individual eligible to enroll in retiree coverage is treated as eligible to purchase minimum essential coverage under an eligible employer-sponsored plan using the same rules applicable to current employees. But, an individual eligible to enroll in continuation coverage required under Federal law, such as COBRA, or a comparable State law, is eligible to purchase minimum essential coverage under an eligible employer-sponsored plan ***only*** if the individual enrolls in the coverage (Preamble, 3,e,i,A).

When self-only coverage doesn't exceed 8% of household income but family coverage does exceed 8% of household income. The required contribution for a spouse and claimed dependents (who are not otherwise exempt) is the premium that the employee would pay for the lowest cost coverage covering the employee, the spouse, and the claimed dependents. The required contribution for self-only coverage under an eligible employer-sponsored plan may cost less than 8% of household income, while the required contribution for family coverage under the same employer plan may cost more than 8% of household income. In such a case, the employee is not exempt, while the employee's spouse and claimed dependents are exempt (Preamble,3,e,i,C).

> **Example—Married employee with dependents.** In 2015, Bernie and Carly file a married joint return, claiming two children, Dallas and Ellie. In November 2014, Bernie is eligible to enroll ***in his employer's 2015 plan***, with self-only coverage costing him $5,000 and family coverage for his spouse and two children costing him another $20,000. Their household income is $90,000. Bernie's required self-only coverage contribution costing $5,000 is affordable coverage for Bernie as it does not exceed 8% of Bernie's household income ($7,200). But, Bernie's required family coverage contribution costing $20,000 is not affordable coverage because their required contribution exceeds 8% of their household income ($7,200) [§1.5000A-3(e)(3)(D), Exp 2].

Employee must timely enroll during employer's open enrollment period. An employee or related individual is treated as eligible for coverage under an eligible employer-sponsored plan for a month during a plan year[37] if the employee or related individual ***could have enrolled*** in the plan for any day in that month ***during an open or special enrollment period***, regardless of whether the employee or related individual is eligible for any other type of minimum essential coverage. COBRA continuation coverage must also be timely enrolled (§1.5000A-3(e)(3)(i)(A) & (B)).

Employees with no dependents must purchase lowest cost self-only coverage; employees with dependents must purchase lowest cost family coverage. The required contribution for an employee eligible to purchase coverage under an eligible employer-sponsored plan is the portion of the annual premium that the employee would pay (whether through salary reduction or otherwise) for the ***lowest cost self-only coverage***. The required contribution to cover an employee's "related individuals" is the portion of the annual premium that the employee would pay (whether through salary reduction or otherwise) for the ***lowest cost family coverage*** (§1.5000A-3(e)(3)(ii)(A) & (B); Preamble,3,e,i,B).

> **Warning.** Some are of the opinion that both husband and wife must purchase health insurance from their own eligible employer-sponsored plan. Only when the husband, for example, can't purchase employer coverage may he be treated as the wife/employee's "related individual" or purchase health insurance in the open market or Exchange (§1.5000A-3(e)(3)(i)(A)).

Individual eligible for two coverages simultaneously. If an employee or related individual is eligible to enroll in an eligible employer-sponsored plan, any eligibility for other coverage (for example, government sponsored minimum essential coverage) is disregarded for purposes of the exemption for lack of affordable coverage (Preamble,3,e,i,C).

Computation of Shared Responsibility Penalty (REG-148500A-12; §1.5000A-4)

As previously discussed, a taxpayer is liable for the shared responsibility payment with respect to any nonexempt individual included in the taxpayer's shared responsibility family. The applicable family size involved for purposes of identifying the appropriate bronze level plan includes only the nonexempt members of the taxpayer's shared responsibility family who do not have minimum essential coverage. Consequently, the applicable national average bronze plan premium may vary from month to month during the year to account for changes in the taxpayer's shared responsibility family (§5000A(b)(1); §5000A(b)(3)(A); Preamble, 4).

Penalty calculation. The penalty is equal to ***the lesser of***:

1. The amount of the national average premium for qualified health plans that:
   - # offer a bronze-level of coverage through an Exchange;
   - # provide coverage for the taxpayer's family size; and
   - # are offered through Exchanges for plan years beginning in the calendar year with or within which the tax year ends (§5000A(c)(1);[38] §1.5000A-4(c)) OR
2. The ***sum of the monthly penalty amounts*** for the tax year (§1.500A-4(a)).

[37] The eligible employer-sponsored plan's regular 12-month coverage period (or the remainder of a 12-month coverage period for a new employee or an individual who enrolls during a special enrollment period) [§1.5000A-3(e)(2)(iii)).

[38] This amount will be released by HHS annually. The amount is unknown at this time.

The amount of the monthly penalty is the greater of (1) a flat fee per household, or (2) a percent of income. Individuals who fail to maintain minimum essential health coverage for any month are subject to a penalty equal to ***the greater of***:

1. A flat dollar amount, or
2. The excess income amount (a percentage of the taxpayer's household income) [§5000A(c)(2); §1.5000A-4(b)(1)].

1. A flat dollar amount per household. The flat dollar amount equals ***the lesser of:***

- # The sum of the applicable dollar amounts ($695) times each uninsured adult in the household who is required to be insured during that month (the fee for an uninsured individual under age 18 is one-half of the adult fee) divided by 12, or
- # 300% of the applicable dollar amount ($695 X 300% = $2,085) divided by 12 (§1.5000A-4(b)(2)).

The applicable dollar amount is phased in as follows:

- # $95 for 2014
- # $325 for 2015
- # $695 in 2016 (§1.500A-4(b)(2)(ii)).

For years after 2016, the $695 penalty amount is indexed for inflation, rounded to the next lowest $50 (§1.5000A-4(b)(2)(iv)). Household income is the sum of the modified AGI of the taxpayer and all individuals accounted for in the family size[39] who are required to file a tax return for that year.[40]

2. The excess income amount (a percentage of household income). This amount equals 2.5% (the income percentage) of the excess of the taxpayer's household income[41] for the taxable year over the threshold amount of income required for income tax return filing for that taxpayer[42] divided by 12. Remember, this penalty doesn't apply for any month if the individual's household income for the year is less than the amount of gross income requiring the filing of a return (§1.5000A-4(b)(3)(i)).

The income percentage is phased in as follows:

- # 1% for 2014
- # 2% in 2015
- # 2.5% beginning after 2015 (§1.5000A-4(b)(3)(ii)).

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[39] Family size is the number of individuals for whom the taxpayer is allowed a personal exemption.

[40] Modified adjusted gross income means adjusted gross income increased by all tax-exempt interest and foreign earned income.

[41] Household income is the sum of the modified AGI of the taxpayer, spouse and all other individuals who are taken into account in determining the taxpayer's family size and are required to file an annual income tax return. This includes children subject to the "kiddie tax" whose unearned income is not reported on the parent's return.

[42] In 2014, the filing threshold is $10,150 for a single person or a married person filing separately and is $20,300 for married filing jointly (§6012(a)(1); IR-2013-4).

Example—the amount of the monthly penalty is the greater of a flat fee or a percent of income. In 2014, the Baldwins file married filing joint with four dependents, three being under 18. Their household income is $150,000 with a filing threshold of $35,600. The Baldwins are all uninsured for the entire year of 2014, resulting in a monthly and annual penalty (shared responsibility payment) of:

Flat dollar penalty calculation. The applicable annual dollar amount for 2014 is $95. This amount is halved for applicable individuals under the age of 18. Thus, the Baldwins alternative #1 annual flat dollar penalty is $427.50 ($95 X 4.5 equivalent adults; that is $95 for each of the three adults, and half that for each of the three children = $427.50). However, the annual flat dollar amount is limited to 300% of $95 = $285, with no adjustment for individuals under 18. As alternative #2 ($285.00) is less than alternative #1 ($427.50), the Baldwins' annual *flat dollar amount* penalty is $285.

Percentage of income penalty calculation. The Baldwins' household income exceeds their filing threshold by $114,400 ($150,000 - $35,600) which is to be multiplied by 1% to get their percentage of income annual penalty amount. Thus, their annual *percentage of income* penalty is $1,144.

2014 annual penalty of $1,144. As the percentage of income penalty ($1,144) is greater than the annual flat dollar amount ($285), the Baldwins' initial annual penalty amount would be $1,144. Assuming the average national annual premium for qualified health plans that offer bronze-level of coverage for a family of six through an Exchange cost $15,000, Baldwin's initial annual penalty amount to be included on their 2014 return would be $1,144.

Example—unmarried taxpayer without minimum essential coverage. In 2016, Gordy is an unmarried individual with no dependents. Gordy's household income is $120,000, substantially above the 2016 applicable filing threshold of $12,000. Gordy does not have minimum essential coverage for any month. The annual national average bronze plan premium for Gordy is $5,000. The 2016 applicable dollar amount is $695. Being single, Gordy's flat dollar amount is $695 (the lesser of $695 and $2,085 ($695 × 3)). Gordy's excess income amount is $2,700 (($120,000 - $12,000) × 2.5%). Therefore, Gordy's monthly penalty amount is $225 (the greater of $58 ($695/12) or $225 ($2,700/12)). The sum of the monthly penalty amounts is $2,700 ($225 × 12). The sum of the monthly national average bronze plan premiums is $5,000 ($5,000/12 × 12). Therefore, Gordy's shared responsibility payment for 2016 is $2,700 (the lesser of $2,700 or $5,000) [§1.5000A-4(d), Exp 1).

Administration and Procedure (REG-148500-12; §1.5000A-5)

IRS administers the penalty but can't get nasty about it. Taxpayers who are required to pay a penalty but fail to do so will receive a notice from the IRS stating that they owe the penalty. The penalty is assessed by the IRS and accounted for as an additional amount of Federal tax owed. The time for assessing the shared responsibility payment is the same time as that prescribed by §6501 for the taxable year including the month for which the taxpayer is liable for the payment. However, the IRS's enforcement provisions are limited:

1. ***Criminal proceedings are limited.*** Noncompliance with the personal responsibility requirement to have health coverage is not subject to criminal or civil penalties.
2. ***Collection proceedings are limited.*** The use of liens and seizures otherwise authorized for collection of taxes does not apply to the collection of this penalty.
3. ***Interest on penalty has been eliminated.*** Interest does not accrue for failure to pay such assessments in a timely manner.

> **Preparer note. *The IRS*** can, and has said it ***will, offset taxpayer refunds*** to collect the penalty for inadequate health insurance coverage (Preamble,5,b).

> **Planning idea.** Should the individual taxpayer drop his or her health insurance coverage and simply pay the very small penalty? Probably not. 83% of individuals had health insurance prior to the ACA health insurance mandate. Why? Peace of mind.

MISCELLANEOUS ACA PROVISIONS

Heath Care Reform Act Increases Penalty on HSA and MSA Distributions

Withdrawals not used for qualified medical expenses are included in gross income in determining federal income taxes and are subject to a penalty tax. Beginning in 2011, ACA increases the additional tax on distributions from an HSA that are not used for qualified medical expenses from 10% to 20% of the disbursed amount. The penalty is waived in cases of disability or death and for individuals age 65 and older.

> **Planning idea**. There are no minimum required distributions from HSA, regardless of the account owner's age. Accumulating money in an HSA may provide tax deferred funds until a time that the client has large unexpected medical expenses.

ALTERNATIVE MINIMUM TAX AND EXEMPTIONS §55 et seq.

Graduated rate schedule and AMT Exemption. For noncorporate taxpayers, AMT consists of two tax rates, 26% and 28%. The AMT exemption amount is phased out at the rate of 25% of every dollar of AMTI in excess of the current year threshold. In 2013 and future years, the AMT exemption amounts, the phaseout threshold and the income threshold between the 26% and the 28% AMT tax rates are all annually adjusted for inflation (Rev. Proc. 2013-35). The following chart contains both the AMT rates and threshold amounts.

Alternative Minimum Tax		2013	**2014**	2015
Unmarried	Exemption AMT: Phaseout range: 28% rate starts:	\$51,900 \$115,400 - \$323,000 \$179,500	**\$52,800** **\$117,300 - \$325,500** **\$182,500**	
Married filing joint	Exemption AMT: Phaseout range: 28% rate starts:	\$80,800 \$153,900 - \$477,100 \$179,500	**\$82,100** **\$156,500 -\$482,900** **\$182,500**	

Married filing separate	Exemption AMT: Phaseout range: 28% rate starts:	$40,400 $76,950 - $238,550 $89,750	**$41,050** **$78,250 - $242,450** **$91,250**	
Estates and trusts	Exemption AMT: Phaseout range: 28% rate starts:	$23,100 $76,950 - $169,350 $179,500	**$23,500** **$78,250 - $172,250** **$182,500**	

Top Five AMT Preference Items

Although there are nearly thirty different preference or adjustment items that contribute to the calculation of AMTI, just two of these amount to nearly 80% of all AMT adjustments. The top five AMT kickers (as provided by the Department of Treasury's Office of Tax Analysis) cover the range of adjustments that we are most likely to see in our client base.

3. State and local tax deductions 62%
4. Personal exemptions 17%
5. Miscellaneous deductions 11%
6. Regular tax NOLs 4%
7. Private activity bond interest 1%
8. All others 5%

Nonrefundable Credits Permanently Allowed to Offset AMT (§26(a)(2); ATRA 2012)
Nonrefundable personal tax credits may be used to offset both regular tax and AMT. ATRA of 2012 made this a permanent part of the tax code. Nonrefundable personal credits include the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the American Opportunity and Lifetime Learning credits, the savers' credit, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit.

The Minimum Tax Credit

The AMT is calculated using two types of adjustments and preferences—deferral items and exclusion items. **Deferral** items generally do not cause a permanent difference in taxable income over time. **Exclusion** items, on the other hand, do cause a permanent difference. The minimum tax credit is allowed only for AMT attributable to deferral items.

Examples of deferral preferences and adjustments:

- Depreciation
- Incentive stock options bargain element on exercise
- Certain passive activity adjustments
- Adjusted basis

The minimum tax credit cannot reduce the ***minimum tax*** in subsequent years. Instead, the credit can reduce the ***regular tax***, but not below the level of the tentative minimum tax for that year. Any unused minimum tax credit carries forward.

KIDDIE TAX (§1(g))

Kiddie Tax Calculation (Rev. Proc. 2013-35)

Generally, the kiddie tax applies to a child if (1) the child has not reached the age of 19 or is a full-time student over age 18 but under age 24 by the close of the taxable year, (2) either of the child's parents is alive at such time, and (3) the child's unearned income exceeds $2,000, and (4) the child does not file a joint return.

Preparer note. Disabled children are not excepted from the age test for kiddie tax purposes.

Under these rules, the net unearned income of a child is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $2,000, less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.

Kiddie tax doesn't apply for child who provides own support. The expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support. Scholarships are not counted in the support test.

The exemption from the kiddie tax for 2014 and 2013 is $2,000. In 2014, a parent is able to elect to include a child's income on the parent's return if the child's income is more than $1,000 and less than $10,000. For 2014, the exemption amount for purposes of the alternative minimum tax will be the lesser of $7,250 ($7,150 in 2013) plus the child's earned income, or $52,800 in 2014 ($51,900 in 2013).

Kiddie Tax and the 3.8% Net Investment Income Tax

Reporting method determines if Kiddie Tax income subject to NII tax. Qualified children and their parents are allowed to report and pay Kiddie Tax in one of two ways (1) Form 8814, Parent's Election to Report Child's Interest and Dividends, where the parent includes the child's unearned income on the parent's 1040; or (2) Form 8615, Tax for Certain Children Who Have Unearned Income, where the child reports the income on the child's Form 1040 and pays tax on unearned income above $2,000 at their parent's tax rate. Parents who report a child's unearned income on their own return must include the unearned income in the parent's calculation of NII, potentially making the child's income to the NII tax. If however, the child reports the income on his or her own return, the NII tax will not apply unless *the child's AGI* exceeds $200,000.

Example. Larry is 16 years old and has dividend income of $6,000. Larry's parents, Roger and Clair, have AGI of $350,000. If Roger and Clair elect to file Form 8814 and report Larry's $6,000 of dividends on their return, the $6,000 of dividends is included as investment income when calculating the NII tax.

Alternative. Assume the same facts as above except that Larry files his own Form 1040, includes Form 8615, and reports the dividends himself. Larry has no other income. While the dividends would still be subject to Roger and Clair's tax rate, Larry's AGI is only $6,000, well below the $200,000 NII threshold for single individuals, and no NII tax would apply. This would save Larry and his parents $228 ($6,000 x 3.8%) of NII tax.

Planning Pointers for the 2014 Kiddie Tax
Delay collections of all unearned income until the child turns 24 and is supporting him/herself with earned income.
Borrow college funds from subsidized loan programs (where interest doesn't accrue until graduation) rather than sell stock where gains are subject to the kiddie tax.
Invest in growth stocks rather than stocks paying dividends, including "tax efficient" mutual funds.
Invest in tax exempt bonds.
Invest in U.S. savings bonds and delay cashing in the bonds until the child is out of the kiddie tax trap.
Move custodial bank accounts (CUTMA balances) into a §529 plan for the child.

INDIVIDUAL TAX CREDITS

HEALTH INSURANCE PREMIUM ASSISTANCE CREDIT

Individuals Without Employer Coverage and Individuals Eligible to Purchase Coverage Only on the Open Market

Individuals must pay for the lowest cost bronze plan available minus any credit from Exchange. In the case of an individual who is ineligible for coverage under an eligible employer-sponsored plan, the required contribution is the premium for the ***applicable plan***, reduced by the maximum amount of any ***§36B credit*** for the taxable year (determined as if the individual was covered for the entire taxable year by a qualified health plan offered through the Exchange serving the rating area where the individual resides). Accordingly, the premium for the lowest cost bronze plan is the same for all individuals in a nonexempt family (§5000A(e)(1)(B)(ii); §1.5000A-3(e)(4)(ii)(A); Preamble,3,e,ii).

Credit allowable under §36B. The §36B allowable credit means the maximum amount of the credit that would be allowable to the individual (or to the taxpayer who can properly claim the individual as a dependent) under §36B if all members of the individual's nonexempt family enrolled in a qualified health plan through the Exchange serving the rating area where the individual resides (§1.5000A-3(e)(4)(ii)(C)).

Health Insurance Premium Assistance Refundable Credit (§36B; §1.36B-0 et seq.)—Effective 2014

Premium assistance credit helps subsidize the purchase of health insurance. A refundable tax credit (called the ***"premium assistance credit"***) is available for an ***"applicable taxpayer"*** for any month that one or more members of the applicable taxpayer's family are:

1. enrolled in qualified health insurance through an Exchange; ***and***

2. not eligible for ***minimum essential health coverage*** from another source, such as employer coverage or government coverage, other than the individual market in the state (for example, the Exchange) [§1.36B2(a)].

Credit not available when minimum essential health coverage is available from employer or government. Accordingly, for a month that an individual included in a nonexempt family is eligible for minimum essential coverage other than coverage in the individual market, the month is not a coverage month for that individual, the individual is not included in the coverage family for purposes of §36B, and no premium assistance amount is allowable for the coverage attributable to such individual (Preamble,3,e,ii,B).

Who is an "applicable taxpayer" (§36B(e)(2); §1.36B-2(b))? To qualify as an applicable taxpayer:

1. Household income[43] (defined later) must be between 100% and 400% of the Federal poverty line[44] (FPL) for the taxpayer's family[45] size ($23,850 to $95,400 for a family of four in 2014 for those in the continental U.S.);
2. If married at the end of the year, the taxpayers must file a joint tax return;
3. The taxpayer must not be claimed as a dependent on another taxpayer's tax return;
4. At the time of enrollment, the taxpayer must be a U.S. citizen or national or an alien lawfully in the U.S. and not be incarcerated; and
5. The taxpayer must be enrolled in a qualified health plan which is certified as eligible to be offered by an Exchange.

Treasury pays the credit directly to the health insurance plan issuer. Income eligibility for purposes of premium tax credits may be determined in advance upon request to an Exchange. Treasury will make advance payments of the credits and reductions to qualified health plan issuers, providing up-front savings to eligible insured individuals. Although the credit is generally payable in advance directly to the insurer, individuals may elect to purchase health insurance out-of-pocket and apply to the IRS for the credit at the end of the taxable year. The amount of the reduction in premium is required to be included with each bill sent to the individual.

The "affordable and adequate" requirement: employer-sponsored plan isn't minimum essential coverage if (1) the required employee's contribution exceeds 9.5% of household income or (2) it doesn't meet the minimum value bronze plan. An employee is not considered eligible for minimum essential coverage under an employer-sponsored plan, including a grandfathered health plan, if the employee's required contribution would exceed 9.5% of his or her household income. In addition, an employer-sponsored plan that provides less than 60% coverage for total allowed costs does not provide minimum essential coverage because it does not provide minimum value. However, neither of these exceptions apply if the employee, or any individual eligible for an employer-sponsored plan by reason of

[43] There seems to be no asset test when determining eligibility.

[44] 2014 Poverty Guidelines for the 48 Contiguous States and the District of Columbia released January 17, 2014.

[45] Family size means the number of individuals in the family, including the taxpayer, spouse, and individuals for whom the taxpayer may properly claim a personal exemption. Family and family size may include individuals who are not subject to or are exempt from the penalty for failing to maintain minimum essential coverage.

relationship to the employee, is covered by the employer-sponsored or grandfathered plan (§36B(c)(2)(C)(i), (ii) & (iii)).

How the "Premium Assistance Credit" is calculated. Applicable individuals report their ***household income*** to an Exchange and then enroll in a health plan offered through the Exchange. Financial information provided to the Exchange is used to calculate the applicable individual's required share of premiums for the health plan. The required share of premiums is then subtracted from the premiums for the second lowest-cost ***silver plan*** adjusted for age (called the ***applicable benchmark plan***) to determine the amount of the premium assistance credit before being adjusted for a sliding percentage of household income. Individuals who fail to pay all or part of the remaining premium amount are given a mandatory three-month grace period prior to an involuntary termination of their participation in the plan (§1.36B-3(d); Preamble,3,e,ii,B).

> **Planning idea.** While premium assistance credits are calculated using the silver level plans, the credit may be used for any plan purchased through an Exchange (i.e., bronze, silver, gold and platinum plans) and, for those eligible, catastrophic plans.

> **Preparer note.** Most Exchanges and numerous websites will do the complicated "premium assistance credit" computation for the taxpayer.

Coverage month. The term "coverage month" means, on the first day of any month, the taxpayer, the taxpayer's spouse, or any dependent is covered by an Exchange's qualified health plan and the premium is paid by the taxpayer or through advance payments of the premium assistance credit (§36B(c)(2)(A)). But, the coverage month does not include any month that the individual is eligible for minimum essential coverage outside the individual market (§36B(c)(2)(B)(i)).

Household income is defined as the sum of (§36B(d)(2)):

1. the taxpayer's ***modified adjusted gross income***, plus
2. the aggregate modified adjusted gross incomes of all other individuals taken into account in determining that taxpayer's family size (but only if such individuals are required to file a tax return for the taxable year).

> **Preparer note.** Household income does not include the modified adjusted gross income of a family member whose sole reason for filing a tax return is to report tax other than income tax (e.g., IRA early distribution penalty or self-employment tax).

Modified adjusted gross income is defined as adjusted gross income increased by:

1. amounts excluded from gross income for citizens or residents living abroad (§911), plus
2. any tax-exempt interest received or accrued during the tax year, plus
3. Social Security benefits excluded from gross income under §86.

The "applicable percentage" table. The premium assistance credit operates on a sliding scale in a linear manner, the result being that as household income increases the taxpayer's required share of contribution increases. This table below shows the percent of income that is required to be paid by the taxpayer toward health insurance.

Household Income percentage of the FPL (Example: family of 4 FPL $23,850 in 2014)	**The Initial Premium percentage is:**	**The Final Premium percentage is**
Up through 133%	2.0%	2.0%
133% through 150%	3.0%	4.0%
150% through 200%	4.0%	6.3%
200% through 250%	6.3%	8.05%
250% through 300%	8.05%	9.5%
300% through 400%	9.5%	9.5%

Inflation adjustments in future. Beginning in 2015, the percentages of income are indexed to the excess of premium growth over income growth for the preceding calendar year (in order to hold steady the share of premiums that enrollees at a given poverty level pay over time.)

Special rule for taxpayers with household income below 100% of the Federal poverty line. Taxpayers whose household income for a taxable year is less than 100% of the FPL for the taxpayer's family size will also be treated as an applicable taxpayer if:

1. The taxpayer or a family member enrolls in a qualified health plan through an Exchange;
2. An Exchange estimates at the time of enrollment that the taxpayer's household income will be between 100% and 400% of the Federal poverty line;
3. Advance credit payments are authorized and paid for one or more months during the taxable year; and
4. The taxpayer would have been applicable taxpayer if the taxpayer's household income for the taxable year was between 100% and 400% of the Federal poverty line (§1.36B-2(b)(6)).

Example of premium credit with $29,500 of household income. Phil is married with two children and paid annual premiums on his silver level health plan of $12,000. Phil's 2014 household income was $29,500 (100%-133% of FPL). Phil is expected to pay 2% of his household income towards his family health insurance premiums. His "premium assistant credit" would be $11,410 ($12,000 premiums less required share of premiums of $590 ($29,500 x 2%)).

Premium Cost		$ 12,000
Household Income	$29,500	
Premium %	x2%	-$ 590
Premium Credit		$ 11,410

Example of premium credit with $90,000 of household income. Phil gets a new job, and his 2014 household income was $90,000 (300%-400% of FPL). Phil is expected to pay 9.5% of his household income towards his family health insurance premiums. His "premium assistant credit" would be $3,450 ($12,000 premiums less required share of premiums of $8,550 ($90,000 x 9.5%)).

Premium Cost		$ 12,000
Household Income	$90,000	
Premium %	x9.5%	-$ 8,550
Premium Credit		$ 3,450

Example—Unmarried individual with no dependents. Gail, a single taxpayer with no dependents, purchases individual coverage from her Exchange for all months in 2014. The annual premium for the lowest cost bronze self-only plan in her rating area (Gail's applicable plan) is $5,000. The adjusted annual premium for the second lowest cost silver self-only plan in her rating area (Gail's applicable benchmark plan) is $5,500.[46] In 2014, Gail's household income is $40,000, which is 358% of the ***Federal poverty line*** for Gail's family size for the taxable year, resulting in a 9.5% applicable percentage. Because each month in 2014 is a coverage month, Gail's §36B maximum credit allowable is the excess of her premium for the applicable benchmark plan over the product of her household income and applicable percentage ($1,700). Therefore, Gail's required contribution is $3,300. Gail lacks affordable coverage for 2014 because her required contribution ($3,300) exceeds 8% of her household income ($3,200) [§1.5000A-3(e)(4)(iii), Exp. 1].

Annual premium for bronze self-only plan:		$ 5,000
Annual premium for silver self-only plan:	$ 5,500	
Individual's required contribution ($40,0000 X 9.5% final premium %)	- 3,800	
§36B maximum credit from Exchange allowable	$ 1,700	-$1,700
#Required contribution		$ 3,300
8% of $40,000 household income		$ 3,200
Result: Coverage not affordable	Negative	

Example—Family. In 2014, Madeline and Nathan, filing a joint return and claiming two children, Paco and Quinn, purchase family health coverage with a $20,000 annual premium from their Exchange. The adjusted annual premium for their applicable benchmark plan is $25,000. Madeline and Nathan's household income is $80,000, which is 347% of the Federal poverty line for a family of four and an applicable percentage of 9.5%. The maximum §36B credit allowable is the excess of the premium for the applicable benchmark plan over the product of the household income and the applicable percentage ($17,400). Therefore, the required contribution is $2,600. Madeline and Nathan have affordable coverage because their required contribution ($2,600) does not exceed 8% of their household income ($6,400) [§1.5000A-3(e)(4)(iii), Exp. 2].

Annual premium for bronze family plan:			$20,000
Annual premium for silver family plan:		$25,000	
Individual's required contribution ($80,0000 X 9.5% final premium %)		- 7,600	
§36B maximum credit from Exchange allowable	$17,400		-$17,400
#Required contribution			$ 2,600
8% of $80,000 household income			$ 6,400
Result: Coverage affordable			Positive

Individual must give limited personal information to Exchange. In applying for enrollment in an Exchange-offered health plan, an individual applicant is required to provide to the Exchange individually

[46] Within the meaning of §1.36B-3(f).

identifiable information, including name, address, date of birth, and citizenship or immigration status. In the case of an individual claiming a premium assistance credit, the individual is required to submit to the Exchange income and family size information and information regarding changes in marital or family status or income.

Eligibility based on income two years back. Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period. Exchange participants provide the Exchange prior year's tax return. This information is used to determine the amount of any credit that will be paid to insurers in the current year. Providing incorrect information to the Exchange may subject the individual to civil penalties, ranging from $25,000 up to $250,000 for supplying fraudulent information.

Too much advance payment of credit may end up as a tax due for the insured. The final credit amount for any given year is based on that year's actual income, even though advance payments may have been made based on a taxpayer's financial situation from two years prior. When the current year tax return is completed, the premium assistance credit may be reduced, but not below zero, by the amount of any advance payment of the credit paid directly to the insurer. If advance payments for a tax year exceed the premium assistance credit allowed, the excess is an increase to the tax imposed for the tax year. But, if a taxpayer's household income is less than 400% of the family size FPL, any tax increase may be limited, (see following chart) [§36B(f)(1); §36B(f)(2)(A); §1.36B-4(a)(3)].

Household income percentage of the FPL	Single Taxpayers	All Other Taxpayers
Less than 200%	$300	$600
At least 200% but less than 300%	$750	$1,500
At least 300% but less than 400%	$1,250	$2,500

Example—Credit overpayment. Manny is single and has no dependents. The Exchange for Manny's rating area projects Manny's 2014 household income will be $27,925 (250% of the FPL for a family of one) and his applicable percentage 8.05%. Manny enrolls in a qualified health plan with annual premiums of $5,200. Manny's advance credit payments are $2,952 ($5,200 less $2,248 ($27,925 × 8.05%).

Manny's actual household income for 2014 is $33,622, which is 301% of FPL. His actual applicable percentage is 9.5% and his actual 2014 premium tax credit is $2,006 ($5,200 less $3,194 ($33,622 × 9.5%)). Because Manny's advance credit payments for 2014 were $2,952 and his 2014 actual credit is $2,006, he has excess advance payments of $946. Manny will owe the $946 with his 2014 tax return. If Manny's excess advance payments exceeded $1,250, his additional tax liability would have been limited to that amount.

Appeal for redetermination possible. Individuals (or couples) who experience a change in marital status or other household circumstance, experience a decrease in income of more than 20%, or receive unemployment insurance, may update eligibility information or request a redetermination of their tax credit eligibility.

ADOPTION CREDIT AND ASSISTANCE PROGRAMS

Adoption Tax Credit (§36C; §137; American Taxpayer Relief Act of 2012 (ATRA))

Adoption rules made permanent by ATRA. Taxpayers that adopt children may claim a tax credit for qualified adoption expenses. A taxpayer may also exclude from income adoption expenses paid by an employer. The credit is phased out for taxpayers with AGI in excess of certain thresholds.

	2013	**2014 (Rev. Proc. 2013-35)**	2015
Adoption Credit	$12,970	**$13,190**	
Phaseout	$194,580 - $234,580	**$197,880 - $237,880**	

> **Planning idea**. The limit applies separately to the credit and the employer benefit exclusion. In other words, as long as adopting parents pay more than $26,380 in qualified 2014 adoption expenses, they may exclude an employer adoption benefit of $13,190 and also claim an adoption credit of $13,190.

Qualified adoption expenses—what? Qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging) and other expenses which are directly related to, and the principal purpose of which is, the legal adoption of an eligible child by the taxpayer. All reasonable and necessary expenses required by a state as a condition of adoption are qualified adoption expenses, including the cost of construction, renovations, alterations or purchases specifically required by the state to meet the needs of the child. Expenses are not qualified adoption expenses if they are:

1. Incurred in violation of state or Federal law,
2. Incurred in carrying out any surrogate parenting arrangement,
3. Incurred in connection with the adoption by an individual of a child who is the child of such individual's spouse, or
4. Reimbursed under an employer program.

Adoption credit—when and how much? The adoption credit is allowed in the earlier of (1) the taxable year following the taxable year the expenses (including expenses for an unsuccessful effort to adopt an eligible child) are paid or incurred, or (2) the taxable year in which the adoption becomes final (See Notice 97-70 and Form 8839 instructions for more explanation).

Foreign adoption. For the adoption of a child who is not a citizen or resident of the United States, no credit is allowed unless the adoption becomes final. Rev. Proc. 2005-31 provides safe harbors for determining the finality of an adoption of a foreign-born child for federal income tax purposes. Foreign adoption expenses are taken into account as if such expenses were paid or incurred during the year that the adoption becomes final (§36C(e)(2)).

Adoption Credit Only Allowable on an MFJ Return, Not Married Separate (*Nancy Field,* TCM 2013-111)

Joint return required for married person. On her 2009 Federal income tax return Nancy Field claimed a status of married filing separate and claimed that she was entitled to a qualified adoption expense credit of $10,144. If the taxpayer is married at the close of the taxable year, the adoption credit is generally allowed only if the taxpayer and his or her spouse file a joint return for that taxable year (§23(f)(1)). Because Mrs. Field was married as of the close of 2009 but did not file a joint return, she was not entitled to an adoption credit.

> **Preparer note.** The IRS has posted adoption benefit FAQs and tax tips (IRS Tax Tip 2013-54) on its website. The FAQs may help your clients answer their own questions about the tax considerations in adopting a child.

TAX BENEFITS FOR EDUCATION

American Opportunity Tax Credit Extended through 2017 (American Taxpayer Relief Act of 2012; American Opportunity Tax Credit, FAQs)

Temporary extension of the American Opportunity Tax Credit. Created under the American Recovery and Reinvestment Act, the American Opportunity Tax Credit is available for up to $2,500 of the cost of tuition and related expenses paid during the taxable year. Under this tax credit, taxpayers receive a tax credit based on 100% of the first $2,000 of tuition and related expenses (including course materials) paid during the taxable year and 25% of the next $2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit is refundable. This tax credit is subject to a phase out for taxpayers with adjusted gross income in excess of $80,000 ($160,000 for married couples filing jointly). ATRA extends the American Opportunity Tax Credit through 2017.

Comparisons of Major Features of the American Opportunity Tax Credit (25A(i)), the Lifetime Learning Credit (25A(c)), and the Higher Education Tuition Deduction (§222)

American Opportunity Tax Credit, Lifetime Learning Credit & Tuition Deduction Comparison			
Feature	**American Opportunity (Hope) Tax Credit**	**Lifetime Learning Tax Credit**	**Higher Education Tuition Deduction**
Type of benefit	40% of the credit is refundable except if a child subject to kiddie tax claims the credit.	Nonrefundable tax credit (cannot exceed tax liability).	Above the line tax deduction (filers do not need to itemize).
Dates applicable	**Extended through 2017**	Indefinite	**Extended through 2013**
Maximum benefit	$2,500 (100% of first $2,000 in qualified expenses, 25% of second $2,000) per student.	$2,000 (20% of first $10,000 in qualified expenses) per return.	$4,000 deduction per return (but only $2,000 maximum deduction available for higher income taxpayers).

American Opportunity Tax Credit, Lifetime Learning Credit & Tuition Deduction Comparison			
Feature	**American Opportunity (Hope) Tax Credit**	**Lifetime Learning Tax Credit**	**Higher Education Tuition Deduction**
Income limit	Credit begins to phase out at $80,000 modified AGI and is fully phased out at $90,000 ($160,000 and $180,000 thresholds for joint returns).	Credit begins to phase out at $54,000 modified AGI and is fully phased out at $64,000 ($108,000 and $128,000 thresholds for joint returns).	Deduction was available to taxpayers with up to $65,000 in modified AGI ($130,000 for joint returns); taxpayers with modified AGI or more than $65,000 but less than $80,000 could claim smaller maximum deduction ($130,000 and $160,000 thresholds for joint returns)
Postsecondary education expenses qualifying for benefit	Tuition, fees, and course materials required for enrollment.	Tuition and fees required for enrollment.	Tuition and fees required for enrollment.
Type of postsecondary education	First 4 years of undergraduate education when enrolled on at least a half-time basis in a program leading to a degree, credential, or certificate.	For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program.	For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program.

RESIDENTIAL ENERGY EFFICIENT PROPERTY §25

Nonbusiness Energy Property Credit (Form 5695)

1. **Residential Energy Efficient Property Credit (§25D).** This tax credit will help individual taxpayers pay for qualified residential alternative energy equipment, such as solar hot water heaters, solar electricity equipment, and wind turbines installed on or in connection with their home located in the United States and geothermal heat pumps installed on or in connection with their main home located in the United States. The credit, which runs through 2016, is 30% of the cost of qualified property, regardless of amount. ARRA removes some of the previously imposed annual maximum dollar limits.

2. **Plug-in Electric Drive Vehicle Credit (§30D).** ARRA modifies this credit for qualified plug-in electric drive vehicles purchased after Dec. 31, 2009. The

minimum amount of the credit for qualified plug-in electric drive vehicles, which runs through 2014, is $2,500 and the credit tops out at $7,500, depending on the battery capacity. ARRA phases out the credit for each manufacturer after it sells 200,000 vehicles.

3. **Nonbusiness energy property credit extended through 2013 (§25C).** ATRA extended the nonbusiness energy property credit through 2013. The $500 lifetime and other credit limitations did not change.

CHILD TAX CREDIT

Modifications to the Child Tax Credit Extended, and in Some Cases Made Permanent (American Taxpayer Relief Act of 2012)

Generally, taxpayers with income below certain threshold amounts may claim the child tax credit to reduce federal income tax for each qualifying child under the age of 17. The EGTRRA increased the credit from $500 to $1,000 and also expanded refundability to 15% of earnings above $10,000. These changes were made permanent by ATRA. The American Recovery and Reinvestment Act of 2009 made further modifications to the credit, lowering the earnings limit for calculating the refundable portion of the credit to $3,000 (from $10,000). ATRA extended this provision through 2017.

> **Planning idea**. The child tax credit begins to phase out when AGI exceeds $110,000 MFJ and $75,000 single and head of household.

See also: *Lorenzo Cooper*, TCS 2013-59, where the child tax credit and the earned income credit were only allowed for a "qualified child" not a "qualified relative."

EARNED INCOME CREDIT §32

Earned Income Tax Credit (EITC Home Page)

2014 Earned Income Base Amounts, Credit Percentages, and Phaseout Amounts (IRS 2014 EIC; Rev. Proc. 2013-35)

The maximum 2014 earned income credit is $6,143 (married filing joint with three children). The earned income base amounts, credit percentages, and phaseout amounts are:

Number of Qualifying Children	Maximum Credit	Complete Phaseout Threshold
No Children	$496	$14,590 ($20,020 MFJ)
One Child	$3,305	$38,511 ($43,941 MFJ)
2 Children	$5,460	$43,756 ($49,186 MFJ)
3+ Children	$6,143	$46,997 ($52,427 MFJ)

> **Example.** In 2014, the maximum credit of $3,350 for one qualifying child is available for married couples whose earnings are between $9,720 and $23,260. The credit begins to phase down at a rate of 15.98% of earnings above $23,260. The credit is completely phased out once earnings of $43,941 are reached.

Third-child EITC extended (American Taxpayer Relief Act of 2012). The American Recovery and Reinvestment Act of 2009 increased the earned income tax credit to 45% (from 40%) of a family's qualifying earned income for families with three or more children. This provision is scheduled to expire in 2018.

Disqualified Income Amount is $3,350 in 2014 (§32(i))
No earned income credit is allowed if the taxpayer has disqualified income in excess of $3,350 for the taxable year.

Filing Form 8867 Mandatory for All EITC Returns (IR-2011-122)

New proposed regulations require paid tax return preparers, beginning in 2012, to file a due diligence checklist, Form 8867, with any federal return claiming the Earned Income Tax Credit (EITC). It is the same form that is currently required to be completed and retained in a preparer's records.

INDIVIDUAL TAX RATES

Tax Rate Schedule

2014 TAX RATE SUMMARY

Filing Status	Tax Computation Taxable Income			Tax Rate	The Tax is:		
Single	$ 1	-	$ 9,075	10%		10% of taxable income	
	$ 9,075	-	$ 36,900	15%	$ 907.50	+15%	>$ 9,075
	$ 36,900	-	$ 89,350	25%	$ 5,081.25	+25%	>$ 36,900
	$ 89,350	-	$186,350	28%	$ 18,193.75	+28%	>$ 89,350
	$186,350	-	$405,100	33%	$ 45,353.75	+33%	>$186,350
	$405,100	-	$406,750	35%	$117.541.25	+35%`	>$405,100
	over		$406,750	39.6%	$118,118.75	+39.6	>$406,750
Head of Household	$ 1		$ 12,950	10%		10% of taxable income	
	$ 12,950	-	$ 49,400	15%	$ 1,295.00	+15%	>$ 12,950
	$ 49,400	-	$127,550	25%	$ 6,762.50	+25%	>$ 49,400
	$127,550	-	$206,600	28%	$ 26,300.00	+28%	>$127,550
	$206,600	-	$405,100	33%	$ 48,434.00	+33%	>$206,600
	$405,100	-	$432,200	35%	$113,939.00	+35%	>$405,100
	over		$432,200	39.6%	$123,424.00	+39.6%	>$432,200
Married, Joint	$ 1		$ 18,150	10%		10% of taxable income	
	$ 18,150	-	$ 73,800	15%	$ 1,815.00	+15%	>$ 18,150
	$ 73,800	-	$148,850	25%	$ 10,162.50	+25%	>$ 73,800
	$148,850	-	$226,850	28%	$ 28,925.00	+28%	>$148,850
	$226,850	-	$405,100	33%	$ 50,765.00	+33%	>$226,850
	$405,100	-	$457,600	35%	$109,587.59	+35%	>$405,100
	over		$457,600	39.6%	$127,962.50	+39.6%	>$457,600
Married, Separate	$ 1	$	9,075	10%		10% of taxable income	
	$ 9,075	-	$ 36,900	15%	$ 907.50	+15%	>$ 9,075
	$ 36,900	-	$ 74,425	25%	$ 5,081.25	+25%	>$ 36,900
	$ 74,425	-	$113,425	28%	$ 14,462.50	+28%	>$ 74,425
	$113,425	-	$202,550	33%	$ 25,382.50	+33%	>$113,425
	$202,550	-	$228,800	35%	$ 54,793.75	+35%	>$202,550
	over		$228,800	39.6%	$ 63,981.25	+39.6%	>$228,800

APPENDIX: GROSS INCOME FILING REQUIREMENT TABLE

Marital Status	Filing Status	Age	2013	2014
Single (including divorced and legally separated)	Single	Under 65	$10,000	$10,150
		65 or older	$11,500	$11,700
	Head of Household	Under 65	$12,850	$13,050
		65 or older	$14,350	$14,600
Married, with a child, living apart from your spouse during the last 6 months of the year	Head of Household	Under 65	$12,850	$13,050
		65 or older	$14,350	$14,600
Married, living with spouse at the end of the year (or on the date the spouse died)	Married, joint return	Both spouses under 65	$20,000	$20,250
		One spouse over 65	$21,200	$21,450
		Both spouses over 65	$22,400	$22,650
	Married, separate return	Any age	$3,900	$3,950
Married, not living with spouse at the end of the year (or on the date the spouse died)	Married, joint or separate return	Any age	$3,900	$3,950
Widowed before 2007 or 2008 and not remarried in 2007 or 2008	Single	Under 65	$10,000	$10,150
		65 or older	$11,500	$11,700
	Head of Household	Under 65	$12,850	$13,050
		65 or older	$14,350	$14,600
	Qualifying widow(er) with dependent child	Under 65	$16,100	$16,350
		65 or older	$17,300	$17,650

2013 FILING REQUIREMENTS FOR DEPENDENTS (2014 figures in *italics & underlined*)

Single under 65 and not blind
- $ Unearned income was more than $1,000 *(1,000)*
- $ Earned income was more than $6,100 *(6,200)*
- $ Gross income was more than the larger of
  - $ $1,000 *(1,000)*, or
  - $ The earned income (up to $5,750 (*5,850*)) plus $350, *(350)*

Married under 65 and not blind
- $ Gross income was at least $5 and the spouse filed a separate return and itemizes deduction
- $ Unearned income was more than $1,000 *(1,000)*
- $ Earned income was more than $6,100 *(6,200)*
- $ Gross income was more than the larger of
  - $ $1,000 *(1.000), or*
  - $ The earned income (up to $5,750) *(5,850)* plus $350, *(350)*

Single 65 or over or blind **$ Unearned income was more than $2,500 *(2,550)* [$4,000 *(4,100)* if 65 or older *and* blind]** **$ Earned income was more than $7,500 *(7,750)* [$9,100 *(9,300)* if 65 or older *and* blind]** **$ Gross income was more than:** **$ The larger of $1,000 *(1,000)*, or the earned income (up to $5,750) *(5,850)* plus $350, *(350)* plus $1,500 *(1,550)* [$3,000 *(3,100)* if 65 or over *and* blind]** **CAUTION: This is current as of 9-18-2014**	**Married 65 or over or blind** **$ Gross income was at least $5 and the spouse filed a separate return and itemizes deductions** **$ Unearned inc. was more than $2,200 *(2,200)* [$3,400 *(3,400)* if 65 or older *and* blind]** **$ Earned income was more than $7,300 *(7,300)* [$8,500 *(8,600)* if 65 or older *and* blind]** **$ Gross income was more than:** **$ The larger of $1,000 *(1,000)*, or the earned income (up to $5,750 *(5,850)*) plus $350 *(350)*,** $ **plus $1,200 *(1,200)* [$2,400 *($2,400)* if 65 or over *and* blind]**

Review Questions

The review questions accompanying each chapter are designed to assist you in achieving the learning objectives stated in the course summary section on the course page of our learning management system and/or at the beginning of each chapter. The review section is not graded; do not submit it in place of your final exam. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions for each chapter, proceed to the review question answers and rationales.

1. Which provision is included in the Affordable Care Act (ACA)?

   a. An increase in the top marginal tax rate from 35% to 39.6%.
   b. The permanence of the inflation-adjusted alternative minimum tax (AMT) exemption.
   c. A new Medicare tax of 3.8% on net investment income for taxpayers with adjusted gross income (AGI) above specified thresholds.
   d. A phase-out limitation on itemized deductions of 3% of AGI above specified thresholds.

2. The 2014 AGI threshold amounts for the phase-out of the personal exemption for a taxpayer filing head of household status is:

   a. $305,050–$427,550.
   b. $279,650–$402,150.
   c. $254,200–$376,700.
   d. $152,525–213,775.

3. Which of the following scenarios violates IRS-mandated basis reporting rules?

   a. An estate executor provides to the estate beneficiaries a written transfer statement that includes the decedent’s date of death, description of securities, and the executor’s valuation of the securities transferred.
   b. A taxpayer, who has made a gift of securities, provides the recipient a written transfer statement disclosing the donor’s purchase date and the basis in the securities transferred.
   c. A transferor broker provides a written transfer statement within 15 days of the settlement date that includes a separate statement for each transferred security and itemizes the acquisition dates and purchase prices to the transferee broker.
   d. A broker provides the taxpayer’s adjusted basis of securities sold, along with a disclosure of whether any gains or losses are long- or short-term for covered securities, on Form 1099-B.

4. A taxpayer loans $20,000 to a friend who needs capital to start a business. A loan agreement dictating the interest rate and terms of repayment is drawn up, signed, and dated by both parties. The friend makes payments on the loan for the first year, but his business fails as does his ability to make payments. The taxpayer issues repeated written requests to his friend for payment and makes unsuccessful attempts to sell the note to an unrelated third party. The taxpayer decides to wait a year to write off the debt when he has a large capital gain from the sale of securities to claim the bad debt deduction. This is an example of which kind of tax planning error?

    a. The taxpayer failed to document the nature and terms of the debt to prove that the note was genuinely a bona fide debt.
    b. The taxpayer failed to prove that this debt was in disguise a capital contribution to his friend's business.
    c. The taxpayer failed to take the bad debt deduction in a timely manner (i.e., when the note became worthless).
    d. The taxpayer failed to prove the efforts he made to collect the debt.

5. Which taxpayer is **INELIGIBLE** to exclude foreign earned income and housing costs from gross income?

    a. A U.S. citizen who is a bona fide resident of a foreign country, but was able to establish to the IRS that he did not meet the 330-day physical presence test because he was required to leave the country due to civil unrest.
    b. A U.S. citizen whose tax home is in a foreign country and who resided in that country for an uninterrupted period that included an entire taxable year.
    c. A U.S. citizen who had a rotational work schedule for two consecutive taxable years of 30 days in a foreign country followed by 30 days in the U.S.
    d. A U.S. citizen whose tax home is in a foreign country and who, during a period of 12 consecutive months, was present in the foreign country during at least 330 full days.

6. A taxpayer has five foreign bank accounts in 2014. Listed below are the names of the accounts, the highest balance during the year, and the income earned from each account. Which of the following statements is accurate regarding filling the Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR)?

    - HSBC: highest balance during 2014 is $1,000; no income earned.
    - HSBC: highest balance during 2014 is $2,000; no income earned.
    - Coutts & Co.: highest balance during 2014 is $3,000; $100 interest income earned.
    - UBS: highest balance during 2014 is $2,000; $50 interest income earned.
    - RBS: highest balance during 2014 is $3,000; $100 interest income earned.

    a. The taxpayer must file the FBAR electronically.
    b. The FBAR is due on June 30, but may be extended to September 30.
    c. The taxpayer is only required to report the accounts that earned income.
    d. The taxpayer is not required to file an FBAR because no account exceeds $10,000.

7. Which asset is excluded from reporting on Form 8938, Statement of Specified Foreign Financial Assets?

   a. Foreign mutual funds.
   b. Foreign-issued life insurance or annuity contract with a cast-value.
   c. A foreign partnership interest.
   d. Foreign real estate held directly by a U.S. individual.

8. Martin was born in the United Kingdom and immigrated to the U.S. when he was 23 years old. He has since become a U.S. citizen. His family, who still resides in the U.K., has established a trust that distributes income each year to all family members, including Martin. What is Martin's filing requirement with respect to reporting ownership in the trust?

   a. A timely filed Form 8938.
   b. A timely filed Form 3520.
   c. A timely filed Form 5471.
   d. A timely filed Form 8865.

9. Which foster care payments are excludable from federal income tax?

   a. Payments made by the government to a biological parent for in-home supportive services to a disabled adult child.
   b. Difficulty of care payments to one individual for the care of more than 10 qualified foster individuals who have not attained age.
   c. Difficulty of care payments to one individual for the care of 5 or more qualified foster individuals who have attained age 19.
   d. Payments to one individual for the additional care of a qualified foster individual who has a physical, mental, or emotional handicap.

10. In a recent court decision, a taxpayer is awarded $50,000 in punitive damages. The attorney's fee is $15,000, leaving the taxpayer with $35,000. What is the tax treatment of these items?

    a. The punitive damages of $50,000 are taxable as ordinary income; the attorney's fees are deductible as an itemized deduction.
    b. The punitive damages of $35,000 are taxable as ordinary income.
    c. The punitive damages are considered non-taxable income; the attorney's fees are non-deductible.
    d. The punitive damages of $50,000 are taxable as ordinary income; the attorney's fees are non-deductible as a personal expense.

11. Which of the following payments is included in gross taxable income?

    a. Worker's compensation.
    b. Damages for personal physical injuries.
    c. Damages received for slander.
    d. Disability income attributable to military injuries.

12. A 35-year old taxpayer has become disabled after an accident. To help with everyday living expenses, she withdrew the balance of her health savings account. What is the penalty for non-qualified distributions?

    a. 10%.
    b. 20%
    c. 40%.
    d. There is no penalty on this distribution.

13. Which of the following statements is accurate in regards to §529, Qualified State Tuition Programs?

    a. Annual contributions to a §529 program are not eligible for the gift tax exclusion.
    b. The contributor may elect to have any contributions in excess of the annual gift exclusion be treated as if made ratably over five years.
    c. Any losses within a §529 program are nondeductible when the donor closes the §529 program.
    d. The interest and dividend income earned on a §529 program is subject to the 3.8% Medicare tax.

14. The following requirements have been set forth in a written divorce decree:

    - Payments of cash, along with the principal residence, will be transferred to the former payee spouse.
    - All payments and transfers will be received by the spouse.
    - The payee spouse and the payor spouse will not live together after date of divorce decree.
    - The cash payments must stop upon the payee spouse's death.
    - The cash payments will be equal amounts over the term of payment.

    What is the taxation of the transfer of the residence and the cash payments?

    a. The residence and the cash payments are alimony payments, which are taxable to the payee spouse and deductible for the payor spouse.
    b. The residence is a tax-free transfer treated as a gift with carryover basis to the payee spouse; the cash payments are child support payments and are excludable from payee spouse's taxable income.
    c. The residence is a tax-free transfer treated as a gift with carryover basis to the payee spouse; the cash payments are non-alimony payments and are excludable from payee spouse's taxable income.
    d. The residence is a tax-free transfer treated as a gift with carryover basis to the payee spouse; the cash payments are alimony payments, which are taxable to the payee spouse and deductible by the payor spouse.

15. Which of the following is an itemized deduction that is subject to the 3% limitation in 2014 for high income taxpayers?

    a. Medical expenses.
    b. Property taxes.
    c. Investment interest.
    d. Gambling losses.

16. Which of the following explains medical insurance premiums for children who under the age of 27?

    a. Premiums are not deductible for any child who is over the age of 22 at the end of the taxable year.
    b. Premiums are deductible for any child under the age of 27 a taxpayer claims as a dependent who is not a son, daughter, stepson, stepdaughter, or eligible foster child of the taxpayer.
    c. Premiums are deductible for only for a child who is a dependent of the tax payer and under the age of 27 at the end of the taxable year.
    d. The insurance company may not deny or restrict coverage for a child who is under 27 based on the child's financial dependency, student status, employment, or residency with the insured.

17. In the Yong J. Dong v. Comm., TCS :2014-4 case, what was the ruling that ultimately caused the denial of the mortgage interest deduction?

    a. The mortgage loan agreement was between two related parties.
    b. Both the deed of trust and the loan agreement were not perfected under state law by recording these legal instruments.
    c. A deed of trust did not exist between the taxpayer and his father.
    d. The loan agreement provided that the home was specific security for the payment of the loan.

18. On August 30, 2014, an individual donates land and a building worth $750,000 to a qualified charity in order for the charity to establish an office and warehouse. The taxpayer attaches Form 8283 to his tax return for the year in which he deducts a charitable contribution of $750,000. A charitable deduction will be denied for the contribution in which of the following scenarios?

    a. The appraisal describes the land and building in sufficient detail for a person who is not generally familiar with the asset to ascertain that the property appraised was the property contributed.
    b. The appraisal of the land and building was completed on March 10, 2015.
    c. The appraisal values a very similar tract of land and building located in the same neighborhood.
    d. The taxpayer attaches a signed Form 8283, completed with appraiser's identifying information and declaration.

19. A tax loss deduction from a Ponzi-type investment scheme (using the procedures in Rev. Proc. 2009-20) must be reported on which section of Form 4684, Casualties and Thefts?

    a. Section A.
    b. Section B.
    c. Section B, Part II.
    d. Section C.

20. Who is excluded from the 3.8% Medicare tax?

    a. U.S. citizens and residents.
    b. Nonresident aliens who have made an IRC Section 6013(g) election.
    c. Bona fide residents of U.S. territories who meet the U.S. filing requirements.
    d. Bona fide residents of mirror code jurisdictions.

21. In 2014, a taxpayer has the following income:

- $123,000 from a W-2 earned as a software engineer
- $2,300 interest income,
- $5,200 interest from municipal bonds
- $6,500 in dividends
- $230 royalty payments
- $2,000 distribution from an IRA
- $23,400 gross income computer programming consulting
- $16,500 from the sale of stocks and securities
- $3,200 from a family limited partnership which holds stocks and securities
- $3,000 from an S corporation that rents tractors and other earth-moving equipment

This taxpayer also has the following:

- $3,200 expenses related to the computer programming consulting
- $8,200 property taxes on principal residence
- $12,000 mortgage interest expense
- $7,200 investment interest expense
- $6,800 investment advisory allocable to taxable interest and dividends
- $480 investment advisory fees allocable to municipal interest expense
- $11,200 capital loss carryover

What is taxpayer's net investment income (NII)?

a. $14,730.
b. $8,250.
c. $5,530.
d. $3,530.

22. Which of the following individuals is exempt from the requirement to maintain minimum health coverage?

a. Exempt noncitizens.
b. Native Americans.
c. Individuals residing outside the U.S.
d. Individuals who have certified that they have suffered a hardship.

23. The IRS will administer the penalty for failure to have adequate health coverage. The IRS is authorized to:

    a. Accrue interest on the penalty.
    b. Place liens on taxpayer's assets.
    c. Offset taxpayer refunds to collect the penalty.
    d. Assess criminal and civil penalties.

24. Which of the following types of income of children must be included in the parent's computation of net investment income?

    a. Interest, dividends, and capital gains of children reported on a parent's Form 8814.
    b. Income amounts excluded from a parent's Form 1040, due to the threshold amounts on Form 8814.
    c. Any amounts attributable to the child's Alaska Permanent Fund Dividends.
    d. Interest income attributable to the child's investment in municipal bonds.

25. Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending _______ year(s) prior to the enrollment period.

    a. One.
    b. Two.
    c. Three.
    d. Five.

26. A U.S. couple has adopted a four-year-old girl with special needs from the country of China with the assistance of an attorney. They have travelled to China twice; the first trip was to meet the little girl, the second trip was to withdraw her from the orphanage and bring her to the U.S. The adoption will be final in 2014. In order to accommodate her special needs, the couple performed extensive renovations to their home to add wheelchair ramps and railings and a handicapped accessible bath tub. The wife's employer reimbursed $10,000 of these expenses. Which expenses are ineligible for the adoption credit?

    a. All expenses are eligible, with the exception of the $10,000 reimbursed by the employer.
    b. Attorney fees to assist with the adoption.
    c. Travel expenses for the first trip to China.
    d. Expenses for the handicapped accessible bath tub.

27. What credit has been extended through 2017?

    a. Residential Energy Efficient Property Credit.
    b. Plug-in Electric Drive Vehicle Credit.
    c. Nonbusiness Energy Property Credit.
    d. Child Tax Credit.

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

1. Which provision is included in the Affordable Care Act (ACA)?

   a. An increase in the top marginal tax rate from 35% to 39.6%. Incorrect. The American Taxpayer Relief Act of 2012 included an increase to the top marginal tax rate from 35% to 39.6% in 2013.
   b. The permanence of the inflation-adjusted alternative minimum tax (AMT) exemption. Incorrect. The American Taxpayer Relief Act of 2012 eliminated the yearly AMT patch by providing for a permanent inflation-adjusted AMT exemption.
   c. A new Medicare tax of 3.8% on net investment income for taxpayers with adjusted gross income (AGI) above specified thresholds. Correct. This new Medicare tax is required under the Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010.
   d. A phase-out limitation on itemized deductions of 3% of AGI above specified thresholds. Incorrect. This re-instituted phase-out limitation was provided for in the American Taxpayer Relief Act of 2012.

2. The 2014 AGI threshold amounts for the phase-out of the personal exemption for a taxpayer filing head of household status is:

   a. $305,050–$427,550. Incorrect. The AGI threshold for married filing joint is $305,050–$427,550.
   b. $279,650–$402,150. Correct. Head of household status has an AGI threshold of $279,650–$402,150 for the phase-out of the personal exemption.
   c. $254,200–$376,700. Incorrect. This phase-out range is for taxpayers with the single filing status.
   d. $152,525–213,775. Incorrect. A taxpayer filing married filing separate with an AGI in the range of $152,525–$213,775 will be subject to the phase-out of personal exemptions.

3. Which of the following scenarios **VIOLATES** IRS-mandated basis reporting rules?

   a. **An estate executor provides to the estate beneficiaries a written transfer statement that includes the decedent's date of death, description of securities, and the executor's valuation of the securities transferred. Correct. While the executor provided a written transfer statement to the beneficiary, the executor did not include the basis of the securities on the transfer statement; therefore, the basis reporting is insufficient according to IRS rules.**
   b. A taxpayer, who has made a gift of securities, provides the recipient a written transfer statement disclosing the donor's purchase date and the basis in the securities transferred. Incorrect. The taxpayer making the gift has complied with the IRS-mandated basis reporting rules for securities transferred via a gift.
   c. A transferor broker provides a written transfer statement within 15 days of the settlement date that includes a separate statement for each transferred security and itemizes the acquisition dates and purchase prices to the transferee broker. Incorrect. The transferor broker has complied with the IRS-mandated basis reporting rules for transferred securities.
   d. A broker provides the taxpayer's adjusted basis of securities sold, along with a disclosure of whether any gains or losses are long- or short-term for covered securities, on Form 1099-B. Incorrect. Beginning Jan. 1, 2011, brokers must include on Form 1099-B the adjusted basis of securities sold and disclose whether the gains or losses are long- or short-term for covered securities.

4. A taxpayer loans $20,000 to a friend who needs capital to start a business. A loan agreement dictating the interest rate and terms of repayment is drawn up, signed, and dated by both parties. The friend makes payments on the loan for the first year, but his business fails as does his ability to make payments. The taxpayer issues repeated written requests to his friend for payment and makes unsuccessful attempts to sell the note to an unrelated third party. The taxpayer decides to wait a year to write off the debt when he has a large capital gain from the sale of securities to claim the bad debt deduction. This is an example of which kind of tax planning error?

   a. The taxpayer failed to document the nature and terms of the debt to prove that the note was genuinely a bona fide debt. Incorrect. A loan agreement was drawn up, which named the taxpayer and the debtor, the interest rate and the terms of repayment. The loan agreement is sufficient for documenting that the debt is considered a bona fide debt.
   b. The taxpayer failed to prove that this debt was in disguise a capital contribution to his friend's business. Incorrect. The taxpayer had no interest in his friend's business; therefore, the debt could not have been a capital contribution in disguise.
   c. The taxpayer failed to take the bad debt deduction in a timely manner (i.e., when the note became worthless). Correct. The taxpayer should have taken the deduction in the year in which the debt was determined to be worthless. In this case, while it is advantageous tax-wise to offset the bad debt deduction with a large capital gain, the debt was not deducted in the year in which it became worthless.
   d. The taxpayer failed to prove the efforts he made to collect the debt. Incorrect. The taxpayer made numerous written attempts to collect the debt. He should have sold the securities at a large capital gain in the year in which the debt became worthless.

5. Which taxpayer is **INELIGIBLE** to exclude foreign earned income and housing costs from gross income?

   a. A U.S. citizen who is a bona fide resident of a foreign country, but was able to establish to the IRS that he did not meet the 330-day physical presence test because he was required to leave the country due to civil unrest. Incorrect. This taxpayer is eligible to exclude foreign earned income and housing costs because he is able to establish to the IRS that he would have meet the 330-day physical presence test, if it were not for the fact he had to leave the country due to civil unrest.
   b. A U.S. citizen whose tax home is in a foreign country and who resided in that country for an uninterrupted period that included an entire taxable year. Incorrect. This taxpayer has met the bona fide residence test and is eligible to exclude foreign earned income and housing costs.
   c. A U.S. citizen who had a rotational work schedule for two consecutive taxable years of 30 days in a foreign country followed by 30 days in the U.S. Correct. This taxpayer is not a bona fide resident of a foreign country, and cannot meet the 330-day physical presence test. Therefore, this taxpayer cannot exclude foreign earned income and housing costs from gross income.
   d. A U.S. citizen whose tax home is in a foreign country and who, during a period of 12 consecutive months, was present in the foreign country during at least 330 full days. Incorrect. This taxpayer is eligible to exclude foreign earned income and housing costs because he has met the 330-day physical presence test.

6. A taxpayer has five foreign bank accounts in 2014. Listed below are the names of the accounts, the highest balance during the year, and the income earned from each account. Which of the following statements is accurate regarding filling the Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR)?

   - HSBC: highest balance during 2014 was $1,000; no income earned.
   - HSBC: highest balance during 2014 was $2,000; no income earned.
   - Coutts & Co.: highest balance during 2014 was $3,000; $100 interest income earned.
   - UBS: highest balance during 2014 was $2,000; $50 interest income earned.
   - RBS: highest balance during 2014 was $3,000; $100 interest income earned.

   a. The taxpayer must file the FBAR electronically. Correct. FBARs must be filed electronically after June 30, 2013.
   b. The FBAR is due on June 30, but may be extended to September 30. Incorrect. No extension of time is available for filing FBARs.
   c. The taxpayer is only required to report the accounts that earned income. Incorrect. Foreign account owners are required to report their accounts, even if the accounts do not generate any taxable income.
   d. The taxpayer is not required to file an FBAR because no account exceeds $10,000. Incorrect. The filing requirement exists when the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.

7. Which asset is excluded from reporting on Form 8938, Statement of Specified Foreign Financial Assets?

   a. Foreign mutual funds. Incorrect. Foreign financial assets are defined under the Foreign Account Tax Compliance Act (FATCA) to include any stock or security from a foreign issuer.
   b. Foreign-issued life insurance or annuity contract with a cast-value. Incorrect. Any contract, interest, or other instrument is included in the definition of foreign financial assets. This includes foreign-issued life insurance or annuity contracts.
   c. A foreign partnership interest. Incorrect. A foreign partnership interest must be reported on the Form 8938 because it is an interest in a foreign financial asset.
   d. Foreign real estate held directly by a U.S. individual. Correct. Foreign real estate is not considered a financial asset; therefore it does not fall under the reporting requirements of Form 8938.

8. Martin was born in the United Kingdom and immigrated to the U.S. when he was 23 years old. He has since become a U.S. citizen. His family, who still resides in the U.K., has established a trust that distributes income each year to all family members, including Martin. What is Martin’s filing requirement with respect to reporting ownership in the trust?

   a. A timely filed Form 8938. Incorrect. Martin is required to file a Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Taxpayers do not have to report a specified foreign financial asset on Form 8938 if it is reported on the timely-filed, appropriate tax form for reporting that particular foreign asset.
   b. A timely filed Form 3520. Correct. The filing requirements for Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, apply to a U.S. person who receives a distribution from a foreign trust.
   c. A timely filed Form 5471. Incorrect. The Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, apply to taxpayers with interests in foreign corporations, not foreign trusts.
   d. A timely filed Form 8865. Incorrect. Martin is not an owner of an interest in a foreign partnership. The Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships, is to be filed when a U.S. person owns an interest in a foreign partnership.

9. Which foster care payments are excludable from federal income tax?

   a. Payments made by the government to a biological parent for in-home supportive services to a disabled adult child. Incorrect. The IRS has historically taken the position that a biological parent of a disabled child may not exclude foster payments because care by a biological parent is not foster care. When litigating this issue, the IRS has argued that a parent may not exclude payments received for in-home supportive services to a disabled adult child, and that an adult child may not exclude payments received for personal care services to a parent
   b. Difficulty of care payments to one individual for the care of more than 10 qualified foster individuals who have not attained age 19. Incorrect. In the case of any foster home, difficulty of care payments are not excludable to the extent that the payments are for more than 10 qualified foster individuals who have not attained age 19.
   c. Difficulty of care payments to one individual for the care of 5 or more qualified foster individuals who have attained age 19. Incorrect. In the case of any foster home, difficulty of care payments are not excludable to the extent that the payments are for 5 or more qualified foster individuals who have attained age 19.
   d. Payments to one individual for the additional care of a qualified foster individual who has a physical, mental, or emotional handicap. Correct. Such difficulty of care payments (compensation to a foster care provider for the additional care required because the qualified foster individual has a physical, mental, or emotional handicap) are excludable if (1) the provider provides the care in the provider's foster family home, (2) a state determines the compensation is needed, and (3) the payor must designate the compensation for this purpose.

10. In a recent court decision, a taxpayer is awarded $50,000 in punitive damages. The attorney’s fee is $15,000, leaving the taxpayer with $35,000. What is the tax treatment of these items?

   a. The punitive damages of $50,000 are taxable as ordinary income; the attorney’s fees are deductible as an itemized deduction. Correct. The gross amount of damages is taxable as ordinary income. The attorney’s fees cannot be netted against the gross damages, but must be deducted as an itemized deduction.
   b. The punitive damages of $35,000 are taxable as ordinary income. Incorrect. The gross amount of damages is taxable as ordinary income ($50,000); the attorney’s fees cannot be netted against the gross damages, but must be taken as an itemized deduction.
   c. The punitive damages are considered non-taxable income; the attorney’s fees are non-deductible. Incorrect. The gross amount of damages is taxable as ordinary income ($50,000); the attorney’s fees cannot be netted against the gross damages, but must be taken as an itemized deduction.
   d. The punitive damages of $50,000 are taxable as ordinary income; the attorney’s fees are non-deductible as a personal expense. Incorrect. The attorney’s fees are deductible as an itemized deduction.

11. Which of the following payments is included in gross taxable income?

  a. Worker's compensation. Incorrect. Amounts received under workers' compensation agreements are excluded from gross taxable income.
  b. Damages for personal physical injuries. Incorrect. The amount of damages received on account of personal physical injuries or physical sickness is excluded from gross taxable income.
  c. Damages received for slander. Correct. Damages received for emotional distress (because of age, race, gender, or disability), libel, slander, and other nonphysical wrongs are included in gross taxable income.
  d. Disability income attributable to military injuries. Incorrect. Amounts received as disability income attributable to injuries incurred as a direct result of a terrorist or military action is excluded from gross taxable income.

12. A 35-year old taxpayer has become disabled after an accident. To help with everyday living expenses, she withdrew the balance of her health savings account. What is the penalty for non-qualified distributions?

  a. 10%. Incorrect. While 10% is the penalty percentage for early withdrawals from IRAs, 401(K), and other retirement plans, non-qualified distributions from HSAs are assessed a 20% penalty.
  b. 20%. Incorrect. The penalty percentage on distributions from an HSA that are not used for qualified medical expenses is 20%; however, the penalty is waived in cases of disability or death and for individuals age 65 and older.
  c. 40%. The penalty percentage on distributions from an HSA that are not used for qualified medical expenses is 20%.
  d. There is no penalty on this distribution. Correct. The 20% penalty on distributions from HSAs (that are not used for qualified medical expenses) is waived in cases of disability or death and for individuals age 65 and over.

13. Which of the following statements is accurate in regards to §529, Qualified State Tuition Programs?

    a. Annual contributions to a §529 program are not eligible for the gift tax exclusion. Incorrect. Contributions to a §529 program will be treated as a completed gift of a present interest from a contributor to a beneficiary. Therefore, annual contributions are eligible for the present exclusion for both the gift tax and generation skipping transfer tax.
    b. The contributor may elect to have any contributions in excess of the annual gift exclusion be treated as if made ratably over five years. Correct. If a contributor makes a donation in one year, in excess of the annual exclusion amount, the contributor may elect to have the contribution treated as if made ratably over five years, beginning in the year the contribution is made.
    c. Any losses within a §529 program are nondeductible when the donor closes the §529 program. Incorrect. While there is no definitive IRS guidance on this issue, if a donor closes the §529 program for the beneficiary and the account balance has dropped below the donor's contributions, the loss may be deductible as a miscellaneous itemized deduction subject to the 2% AGI limitations.
    d. The interest and dividend income earned on a §529 program is subject to the 3.8% Medicare tax. Incorrect. Income that is tax-exempt for income tax purposes is not subject to the 3.8% Medicare tax; therefore, the 3.8% Medicare tax can be avoided if the income earned on a §529 program is used tax-free for college expenses.

14. The following requirements have been set forth in a written divorce decree:

    - Payments of cash, along with the principal residence, will be transferred to the former payee spouse.
    - All payments and transfers will be received by the spouse.
    - The payee spouse and the payor spouse will not live together after date of divorce decree.
    - The cash payments must stop upon the payee spouse's death.
    - The cash payments will be equal amounts over the term of payment.

    What is the taxation of the transfer of the residence and the cash payments?

    a. The residence and the cash payments are alimony payments, which are taxable to the payee spouse and deductible for the payor spouse. Incorrect. Transfers of property do not qualify as alimony; therefore, the house is considered a gift to the payee spouse.
    b. The residence is a tax-free transfer treated as a gift with carryover basis to the payee spouse; the cash payments are child support payments and are excludable from payee spouse's taxable income. Incorrect. The cash payments to the payee spouse meet the six tests of §71 and are considered alimony, which is taxable to the payee spouse and deductible by the payor spouse.
    c. The residence is a tax-free transfer treated as a gift with carryover basis to the payee spouse; the cash payments are non-alimony payments and are excludable from payee spouse's taxable income. Incorrect. Payments are not alimony only if the divorce decree designates payments as excludable from the payee spouse's gross income.
    d. The residence is a tax-free transfer treated as a gift with carryover basis to the payee spouse; the cash payments are alimony payments, which are taxable to the payee spouse and deductible by the payor spouse. Correct. The six tests of §71 are met by the provisions of the divorce decree; therefore, the payments are alimony, taxable to the payee and deductible by the payor. The residence is a transfer of property to a former spouse that is incident to divorce, which is tax-free and considered a gift.

15. Which of the following is an itemized deduction that is subject to the 3% limitation in 2014 for high income taxpayers?

    a. Medical expenses. Incorrect. Medical expenses are already subject to a limitation of 10% beginning in 2013 and are not subject to additional 3% excess AGI limitation.
    b. Property taxes. Correct. The 3% excess AGI limitation on itemized deductions for high income taxpayers applies to expenses that are not limited under other provisions. This would include such expenses as property taxes, charitable contributions, and mortgage interest.
    c. Investment interest. Incorrect. Investment interest expense is limited to total investment income. The deduction for investment interest is not included in the new 3% excess AGI limitation.
    d. Gambling losses. Incorrect. Gambling losses are excluded from the 3% excess AGI limitation because such losses are already limited to gambling income.

16. Which of the following accurately explains medical insurance premiums for children who under the age of 27?

    a. Premiums are not deductible for any child who is over the age of 22 at the end of the taxable year. Incorrect. Under the Affordable Care Act, taxpayers may deduct (subject to appropriate limitations) medical insurance premiums for a child who has not attained the age of 27 as of the end of the taxable year.
    b. Premiums are deductible for any child under the age of 27 a taxpayer claims as a dependent who is not a son, daughter, stepson, stepdaughter, or eligible foster child of the taxpayer. Incorrect. Under the Affordable Care Act, taxpayers may deduct (subject to appropriate limitations) medical insurance premiums for a child who has not attained the age of 27 as of the end of the taxable year. For this provision, the term "child" means only an individual who is a son, daughter, stepson, stepdaughter, or eligible foster child of the taxpayer.
    c. Premiums are deductible for only for a child who is a dependent of the tax payer and under the age of 27 at the end of the taxable year. Incorrect. Premiums are deductible for a child who is under 27, even if the child is not a dependent of the taxpayer.
    d. The insurance company may not deny or restrict coverage for a child who is under 27 based on the child's financial dependency, student status, employment, or residency with the insured. Correct. Insurance providers must make coverage available for children until attainment of 27 years of age. The provider may not deny or restrict coverage based on any one, or combination of, factors that include financial dependency, student status, employment, or residency with the insured.

17. In the Yong J. Dong v. Comm., TCS :2014-4 case, what was the ruling that ultimately caused the denial of the mortgage interest deduction?

   a. The mortgage loan agreement was between two related parties. Incorrect. The denial of the mortgage interest deduction was not based on the related party aspect of this case.
   b. Both the deed of trust and the loan agreement were not perfected under state law by the recording these legal instruments. Correct. The court upheld the IRS determination that disallowed the mortgage interest deduction because neither the loan agreement nor the deed of trust were properly secured under state law. The court ruled that, in the event of a default, Yong's unrecorded mortgage would not be sufficient to subject his residence to the satisfaction of the debt with the same priority as a recorded mortgage because the unrecorded mortgage is valid only against a third person having actual notice of it. It was further determined that neither the deed of trust nor the loan agreement between Yong and his parents were perfected under New York state law and ruled the interest he paid to his parents was not deductible.
   c. A deed of trust did not exist between the taxpayer and his father. Incorrect. A deed of trust did exist between the taxpayer and his father; therefore, this was not the ruling that caused the denial of the deduction.
   d. The loan agreement provided that the home was specific security for the payment of the loan. Incorrect. The loan agreement did provide that the home was specific security for the payment of the loan; therefore, this was not the ruling that caused the denial of the deduction.

18. On August 30, 2014, an individual donates land and a building worth $750,000 to a qualified charity in order for the charity to establish an office and warehouse. The taxpayer attaches Form 8283 to his tax return for the year in which he deducts a charitable contribution of $750,000. A charitable deduction will be denied for the contribution in which of the following scenarios?

    a. The appraisal describes the land and building in sufficient detail for a person who is not generally familiar with the asset to ascertain that the property appraised was the property contributed. Incorrect. An appraisal that describes the land and building in sufficient detail, in order to identify the contributed property, is not a defective appraisal.
    b. The appraisal of the land and building was completed on March 10, 2015. Incorrect. Under the IRS regulations, a qualified appraisal must be made no more than 60 days before the gift and no later than the due date of the return. As the due date of the return for this individual is April 15, 2015, the appraisal was completed in sufficient time to be valid.
    c. The appraisal values a very similar tract of land and building located in the same neighborhood. Correct. The appraisal must be of the actual contributed property; not a similar property or a hypothetical property. This will cause the disallowance of the deduction.
    d. The taxpayer attaches a signed Form 8283, completed with appraiser's identifying information and declaration. Incorrect. The form was completed correctly; therefore, this would not cause the denial of the deduction. Form 8283 must include the appraiser's name, address, identifying number, and the appraiser's declaration. Furthermore, the Form 8283 must contain the donee's signature.

19. A tax loss deduction from a Ponzi-type investment scheme (using the procedures in Rev. Proc. 2009-20) must be reported on which section of Form 4684, Casualties and Thefts?

    a. Section A. Incorrect. Section A of Form 4684 is to report the casualty or theft loss from personal use property.
    b. Section B. Incorrect. A taxpayer will report a casualty or theft loss from each separate business and income-producing property in Section B.
    c. Section B, Part II. Incorrect. Section B, Part II reports the summary of gains and losses from all business and income-producing properties listed in Part I.
    d. Section C. Correct. Section C will be used to report a theft loss deduction for Ponzi-type investment schemes using Rev. Proc. 200-20, as modified by Rev. Proc. 2011-68.

20. Who is excluded from the 3.8% Medicare tax?

a. U.S. citizens and residents. Incorrect. Any citizen or resident of the United States is subject to the 3.8% Medicare tax.
b. Nonresident aliens who have made an IRC Section 6013(g) election. Incorrect. The 3.8% Medicare tax applies to any nonresident alien who has made an IRC Section 6013(g) election to be treated as a U.S. resident. If the nonresident alien has not made this election, then the Medicare tax does not apply.
c. Bona fide residents of U.S. territories who meet the U.S. filing requirements. Incorrect. A bona fide resident of a U.S. territory is subject to the 3.8% Medicare tax if the individual is required to file a U.S. income tax return.
d. Bona fide residents of mirror code jurisdictions. Correct. A mirror code system of taxation means the income tax laws are generally identical to the Internal Revenue Code. The 3.8% Medicare tax generally does not apply to bona fide residents of "mirror code" jurisdictions because they will not have an income tax liability to the U.S. if they fully comply with the tax laws of the relevant territory.

21. In 2014, a taxpayer has the following income:

- $123,000 from a W-2 earned as a software engineer
- $2,300 interest income
- $5,200 interest from municipal bonds
- $6,500 in dividends
- $230 royalty payments
- $2,000 distribution from an IRA
- $23,400 gross income computer programming consulting
- $16,500 from the sale of stocks and securities
- $3,200 from a family limited partnership which holds stocks and securities
- $3,000 from an S corporation that rents tractors and other earth-moving equipment

This taxpayer also has the following:

- $3,200 expenses related to the computer programming consulting
- $8,200 property taxes on principal residence
- $12,000 mortgage interest expense
- $7,200 investment interest expense
- $6,800 investment advisory allocable to taxable interest and dividends
- $480 investment advisory fees allocable to municipal interest expense
- $11,200 capital loss carryover

What is taxpayer's net investment income (NII)?

a. $14,730. Incorrect. A simplified formula for NII is: the excess of taxable gross income from interest, dividends, annuities, royalties, rents, income derived from a passive activity, and net capital gain or loss over deductions properly allocable to such gross income or net gain. The amount $14,730 fails to deduct the $11,200 of capital loss carryover.
b. $8,250. Incorrect. The simplified NII formula applied to this example results in $3,530 of NII. The $8,250 includes the nontaxable income from muni bonds and the investment advisory fees allocable to the muni bonds.
c. $5,530. Incorrect. The $5,530 erroneously includes the $2,000 distribution from the IRA.
d. $3,530. Correct. The simplified NII formula applied to this scenario results in $3,530 of NII.

22. Which of the following individuals is exempt from the requirement to maintain minimum health coverage?

    a. Exempt noncitizens. Correct. Exempt noncitizens are exempt from the requirement to maintain minimum essential health coverage for the months they were exempt noncitizens. Others exempt include members of recognized religious sects, a member of the health care sharing ministry, and incarcerated individuals.
    b. Native Americans. Incorrect. Although not exempt from the requirement to maintain minimum essential health coverage, members of federally recognized Indian tribes are exempt from having to pay the penalty for failure to maintain the health coverage.
    c. Individuals residing outside the U.S. Incorrect. Individuals residing outside the U.S. are exempt from the penalty, but not the requirement to maintain coverage because they are treated as being covered by acceptable coverage during any month that they are bona fide residents of any U.S. possession.
    d. Individuals who have certified that they have suffered a hardship. Incorrect. The Exchange will issue a hardship exemption certificate waiving the penalty when the individual certifies that the particular hardship makes it impossible to obtain minimum essential health coverage.

23. The IRS will administer the penalty for failure to have adequate health coverage. The IRS is authorized to:

    a. Accrue interest on the penalty. Incorrect. The IRS is not permitted to accrue interest for failure to pay the penalty.
    b. Place liens on taxpayer's assets. Incorrect. The use of liens and seizures otherwise authorized for collection of taxes does not apply to the collection of the penalty.
    c. Offset taxpayer refunds to collect the penalty. Correct. The IRS is authorized to offset taxpayer tax refunds to collect the penalty for inadequate health coverage.
    d. Assess criminal and civil penalties. Incorrect. Any non-compliance with the requirement to carry adequate health insurance is not subject to criminal or civil penalties.

24. Which of the following types of income of children must be included in the parent's computation of net investment income?

   a. Interest, dividends, and capital gains of children reported on a parent's Form 8814. Correct. The amounts of net investment income that are included on a parent's Form 1040 (by reason for Form 8814) are included in calculating the parent's net investment income.

   b. Income amounts excluded from a parent's Form 1040, due to the threshold amounts on Form 8814. Incorrect. Any amounts of their children's interest, dividends, and capital gains that are not included in taxation of the parent's Form 1040 because of Form 8814 threshold amounts will not be included in the parent's calculation of net investment income.

   c. Any amounts attributable to the child's Alaska Permanent Fund Dividends. Incorrect. The net investment income calculation does not include any amounts attributable to Alaska Permanent Fund Dividends.

   d. Interest income attributable to the child's investment in municipal bonds. Incorrect. Interest income from municipal bonds is tax-exempt; therefore, whether it belongs to the parent or the child, this interest would not be included in the calculation of net investment income.

25. Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending ________ year(s) prior to the enrollment period.

   a. One. Incorrect. Eligibility is based on the individual's income two preceding tax years, not one.

   b. Two. Correct. Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period.

   c. Three. Incorrect. Eligibility is based on the individual's income for two preceding tax years prior to enrollment, not three.

   d. Five. Incorrect. Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period.

26. A U.S. couple has adopted a four-year-old girl with special needs from the country of China with the assistance of an attorney. They have travelled to China twice; the first trip was to meet the little girl, the second trip was to withdraw her from the orphanage and bring her to the U.S. The adoption will be final in 2015. In order to accommodate her special needs, the couple performed extensive renovations to their home to add wheelchair ramps and railings and a handicapped accessible bath tub. The wife's employer reimbursed $10,000 of these expenses. Which expenses are ineligible for the adoption credit?

    a. All expenses are eligible, with the exception of the $10,000 reimbursed by the employer. Correct. Expenses are not qualified adoption expenses if they are reimbursed under an employer program.
    b. Attorney fees to assist with the adoption. Incorrect. Qualified adoption expenses include any reasonable and necessary adoption fees, attorney fees, and court costs directly related to the legal adoption of an eligible child by the taxpayer.
    c. Travel expenses for the first trip to China. Traveling expenses (including amounts spent for meals and lodging) are considered reasonable and necessary adoption expenses if incurred by a taxpayer with the principal purpose to legally adoption an eligible child.
    d. Expenses for the handicapped accessible bath tub. Incorrect. Any costs of construction, renovations, alternations, or purchases specifically required by the state to meet the needs of the child are considered qualified adoption expenses.

27. What credit has been extended through 2017?

    a. Residential Energy Efficient Property Credit. Incorrect. This credit, which helps taxpayers pay for qualified residential alternative energy equipment, has been extended through 2016.
    b. Plug-in Electric Drive Vehicle Credit. Incorrect. The Plug-in Electric Drive Vehicle Credit has been extended through 2014. The credit is $2,500–$7,500 for any qualified plug-in electric drive vehicle purchased after December 31, 2009.
    c. Nonbusiness Energy Property Credit. Incorrect. The $500 nonbusiness energy property credit has been extended through 2013.
    d. Child Tax Credit. Correct. The Child Tax Credit, which permits taxpayers with income below certain threshold amounts to claim up to $1,000 for each qualifying child under the age of 17, is set to expire in 2017.

Glossary

This is a glossary of key terms with definitions. Please review any terms with which you are not familiar.

3.8% Medicare tax: A new tax beginning in 2013 implemented by the Affordable Care Act of 3.8% on net investment income for married couples with AGI over $250,000 and single taxpayers with AGI over $200,000.

Adoption tax credit: A tax credit provided to taxpayers who adopt children and incur qualified adoption expenses.

Affordable Care Act (ACA): Legislation passed implementing fundamental health care reforms and requires many of the 32 million uninsured individuals to obtain health care coverage or pay a penalty.

Alimony: A payment of cash to a former spouse meeting the six objective tests set forth in IRC §71.Alimony is deductible from income by the payor spouse and includible in income of the payee spouse.

Alternative minimum tax (AMT): A tax computation on individuals and businesses that is calculated using adjustments and preferences.

American Opportunity Tax Credit: A credit available through 2017 to a taxpayer for expenses paid for the taxpayer or dependent's first four years of an undergraduate education when the individual is enrolled at least a half-time basis in a program leading to a degree, credential, or certificate. The credit has limitations based upon taxpayer's AGI and can be no more than $2,500.

American Taxpayer Relief Act of 2012 (ATRA): Tax legislation passed on January 1, 2013 that extended or made permanent several expiring provisions and made permanent the *AMT* "patch."

Bad debt deduction: A deduction that is allowed for any debt that becomes worthless within the taxable year.

Basis reporting rules: Beginning January 1, 2011, brokers must include on Forms 1099-B the taxpayer's adjusted basis of securities sold and disclose whether any respective gains or losses are long- or short-term for "covered securities."

Cancellation of debt income (COD): Income that occurs when debt is discharged through bankruptcy, foreclosure, the statute of limitations making the debt unenforceable, when the debt goes through probate, by agreement between the creditor and debtor, or when the creditor decides to discontinue collection efforts and discharges the debt.

Casualty loss: A loss that arises from an event that is identifiable, damaging to property, sudden, unexpected, and unusual in nature.

Child Tax Credit: Taxpayers with income below certain threshold amounts may claim a credit for each qualifying child under the age of 17.

Community property states: Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Conservation easement: A qualified real property interest that is used for the preservation of a certified historic structure.

Coverdell Education Savings Account: A tax exempt savings account used to pay for education expenses of a designated beneficiary. The annual contribution limit is $2,000.

Custodial parent: The parent who has the right under state law to physical custody for more than one-half of the taxable year.

Difficulty of care payment: Compensation to a foster care provider for the additional care required because the qualified foster individual has a physical, mental, or emotional handicap.

Educator deduction: An above-the-line deduction available through 2013 for teachers and other school professionals for expenses paid or incurred for books, supplies, computer equipment, other equipment, and supplementary materials used by the educator in the classroom.

Foreign earned income and housing exclusion: An exclusion from earned income for qualified individuals that, in 2013, equals the foreign earned income exclusion of $97,600 and the foreign housing cost exclusion of $15,616 ($97,600 x 16%) or higher in some high costs areas designated in Notice 2013-31.

Foreign earned income: the amount received by an individual from sources within a foreign country that constitute earned income attributable to services performed by an individual.

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts: A form used by a U.S. citizen to report transactions with foreign trusts and the receipt of gifts from foreign sources.

Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent: A form used by the custodial parent of a child to release a claim to exemption for the child so that the noncustodial parent can claim an exemption for the child, or to revoke a previous release of claim to exemption for a child.

Form 8938, Statement of Specified Foreign Financial Assets: A form that an individual is required to complete and attach to the tax return if the taxpayer has an aggregate balance of more than $50,000 ($150,000 for citizens living abroad) in foreign financial assets. Domestic entities and non-filers are exempt from filing Form 8938.

Form 8949, Sales and Dispositions of Capital Assets: The form used to report details of short- and long-term capital gain or loss transactions, the sale or exchange of capital assets not reported on other forms or schedules, gains from involuntary conversions of capital assets not held for business or profit, and nonbusiness bad debts.

Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States: A form used by individuals required to allocate income in community property states.

Form 8960, Net Investment Income Tax: The form used to compute the 3.8% Medicare tax on net investment income.

Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts: A form that must be filed by June 30 (no extensions) of each year when the filer has a financial interest in, or signature authority (or other authority that is comparable to signature authority) over one or more accounts in a foreign county, and the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.

Foster care payment: Payments made from various governmental agencies to providers who care for a qualified foster individual in the provider's home.

Health insurance premium assistance refundable credit: A refundable tax credit that is available for an applicable taxpayer for any month that one or more members of the applicable taxpayer's family are enrolled in qualified health insurance through an Exchange, and not eligible for minimum essential health coverage from another source, such as employer coverage or government coverage, other than the individual market in the state.

Health savings account (HSA): A tax-advantaged medical savings account available to taxpayers who are enrolled in a high-deductible health plan.

Insurance exchange: States are required to establish, under the Affordable Care Act, an open market whereby individuals and small business with 100 or few employees can purchase qualified coverage from a choice of certified health plans rated by the Exchange. The Exchanges will be administered by a governmental agency or nonprofit organization.

Kiddie tax: A tax that applies to any child that has not reached the age of 19, is a full-time student over age 18 but under age 24 by close of the taxable year, either of the child's parents is alive at such time, and the child's unearned income exceeds $2,000 (in 2013), and the child does not file a joint return.

Lifetime Learning Tax Credit: A credit available to a taxpayer for expenses paid for the taxpayer or dependent's tuition and fees required for any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of the program. The credit has limitations based upon taxpayer's AGI and can be no more than $2,000.

Marriage bonus: A marriage bonus occurs in the tax system when a couple pays less income tax filing “married filing jointly” than they would if they were not married and filed as “single” filing status.

Marriage penalty: A marriage penalty occurs in the tax system when a couple pays more income tax filing “married filing jointly” than they would if they had remained single and filed as “single” filing status.

Mexican Land Trust (MLT): A financial vehicle in which non-Mexican persons may hold residential real property located in certain restricted zones in Mexico.

Minimum essential health coverage: A taxpayer is considered to possess minimum essential health coverage for purposes of the *ACA* if the tax payer is covered by either a government sponsored health program, an eligible employer-sponsored plan, a plan available in the individual (non-group) market and plans offered by an Exchange, grandfathered group health plan, self-funded student health plan, Refugee Medical Assistance plan supported by the Administration for Children and Families, or state health benefits risk pool.

Net investment income: Computed for purposes of the 3.8% Medicare tax, is the excess of the sum of gross income (from interest, dividends, annuities, royalties, rents, passive activity trade or businesses, income derived from the trade or business of trading in financial instruments or commodities, and the net gain attributable to the disposition of property other than property held in any trade or business) less the deductions properly allocable to such gross income or net gain, including investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in net investment income.

Offshore Voluntary Disclosure Program (OVDP): A voluntary disclosure program created by the IRS for taxpayers who did not report foreign accounts and taxable income from these accounts in the prior years. If a taxpayer resolves the disclosure and reporting issues under the OVDP, the taxpayer will be subject to a reduced penalty framework.

Personal exemption phase-out: Beginning in 2013, personal exemption deductions are phased out for high income taxpayers. The phase out is equal to 2% of the exemption for each $2,500 (or fraction thereof) of adjusted gross income (AGI) in excess of a threshold amount determined by filing status and AGI.

Plug-in Electric Drive Vehicle Credit: A credit available for taxpayer’s purchasing qualified plug-in electric drive vehicles purchased after December 31, 2009.The minimum amount of the credit is $2,500 and tops out at $7,500.The credit expires for years after 2014.

Ponzi-scheme: A fraudulent investment scheme whereby the investor is paid from money from other investors rather than from profit earned by the organization operating the scheme.

Qualified adoption expenses: Reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including meals and lodging), and other expenses that are directly related to, and for, the principal purposes of the legal adoption of an eligible child by the taxpayer.

Qualified appraisal: An appraisal required to document non-cash contributions exceeding $5,000 including a detailed description of the property, the date or expected date of the contributions, the terms of any agreement or understanding related to the use of the donated property, a statement that the appraisal was prepared for income tax purposes, and the fair market value on the date of the contribution.

Qualified foster care placement agency: A placement agency that is licensed or certified for the foster care program of a state or political subdivision of a state.

Qualified foster individual: Any individual living in a foster family home in which the individual was placed by an agency of a state or political subdivision or by a qualified foster care placement agency.

Qualified higher education expense deduction: An above-the-line deduction allowed through 2013 by qualified taxpayers for qualified higher education expenses paid by the taxpayer during a taxable year, subject to *AGI* limitations based on filing status.

Qualified individual (for foreign earned income purposes): An individual whose tax home is in a foreign country, a citizen of the U.S., established as a bona fide resident of a foreign country or countries for an uninterrupted period including an entire taxable year, or a citizen or resident of the U.S. who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

Qualified residence interest: Interest paid on mortgages incurred to purchase, build, or improve a qualified residence or second home.

Qualified residence: A qualified residence, for purposes of mortgage interest deduction, including a house, condominium, cooperative, mobile home, house trailer, boat, or similar property, and a second residence if the residence contains sleeping, cooking, and toilet facilities.

Qualified State Tuition Programs §529 Plan: A program established and maintained by a state, or agency allowing the prepayment of, or contribution to, an account for the purposes of paying the qualified higher education expenses at an eligible educational institution.

Qualifying child: In order for a taxpayer to take a dependency exemption for a child, the child must not have attained the age of 19 by the end of the calendar year, be a student that has not attained the age of 24 by the end of the calendar year, be younger than the taxpayer, have the same principal place of abode as the taxpayer for more than ½ of the year, not provide more than half of the child’s support for the year, and not have filed a joint return.

Qualifying relative: In order for a taxpayer to take a dependency exemption for a person other than a qualifying child, the relative must be related to the taxpayer or have the same principal place of abode for the tax year, have had the taxpayer furnish over half of the total support for that calendar year, not be a qualifying child of the taxpayer or any other taxpayer for the tax year, and have gross income for the calendar year less than $3,900 (in 2013).

Registered domestic partner (RDP): One half of a couple, typically same-sex, who files a notice of a committed long-term relationship with a jurisdiction that recognizes such unions.

Residential Energy Efficient Property Credit: A credit designed to help individual taxpayers pay for qualified residential alternative energy equipment. The credit runs through 2016 and is 30% of the cost of the qualified property.

Residential energy efficient property: Includes solar hot water heaters, solar electricity equipment, wind turbines, and geothermal heat pumps installed on or in connection with a taxpayer's home located in the U.S.

Shared Responsibility Penalty Calculation: A penalty assessed against individuals for failure to carry minimum essential health coverage.

Theft loss: A loss that arises from the unlawful taking and removing of money or property with the intent to deprive the owner of it including larceny, embezzlement, and robbery.

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Final Examination

2014 Individual & Employee Federal Tax Update
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1. Which provision was made permanent by the American Taxpayer Relief Act of 2012?

    a. Residential energy credit.
    b. A 15-year recovery period for qualified leasehold improvements, qualified restaurant property, and qualified retail improvements.
    c. A 100% gain exclusion for qualified §1202 stock.
    d. $1,000 child tax credit.

2. Which provision of the Affordable Care Act becomes effective in 2015?

    a. FSA contributions limited to $2,500.
    b. The 3.8% Medicare tax assessed on net investment income.
    c. Reporting of large employer health insurance coverage.
    d. The shared responsibility penalty.

3. For filing years beginning in 2013, legally-married, same-sex couples must file their tax returns using the following filing status:

    a. Single.
    b. Either single, married filing jointly, or married filing separately.
    c. Either married filing jointly or married filing separately.
    d. Either single or married filing separately.

4. Which IRS form is used to allocate income between married individuals residing in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin?

    a. Form 7598.
    b. Form 8958.
    c. Form 9238.
    d. Form 9728.

5. Which of the following is considered a marriage bonus?

   a. The allowance of $25,000 for actively managed rental real estate losses.
   b. The Child and Dependent Care Credit.
   c. The reinstated phase-out of personal exemptions.
   d. The excluded employer-provided health insurance.

6. In which of the following scenarios would the dependency exemption be **DISALLOWED** by the IRS?

   a. A taxpayer claims an exemption for his 21-year-old child who lives with the taxpayer for the entire year, is working full time, and is not attending college or technical school.
   b. A taxpayer claims an exemption for her first cousin's child because the child lives with her all year, and she provides more than half of the child's support.
   c. A taxpayer claims an exemption for his unemployed fiancé's mother because she lives with him for the entire tax year while he pays all of her living expenses.
   d. A taxpayer who is divorced, has a higher AGI than her ex-husband, and claims an exemption for her child who lives exactly half of the year with her and half of the year with her ex-husband.

7. For a taxpayer with an effective tax rate of 28% in 2014, the tax on long-term capital gains and qualified dividends is:

   a. 0%
   b. 15%.
   c. 20%.
   d. 39.6%.

8. A taxpayer has made the following stock purchases in publicly-traded ABC Company:

   - 100 shares at $24.81 on July 15, 2009.
   - 50 shares at $23.21 on September 15, 2009.
   - 50 shares at $25.63 on March 18, 2010.
   - 100 shares at $27.29 on January 10, 2011.

   On April 12, 2014, the taxpayer sells 250 shares. The shares were delivered to the buyer on April 14, 2014. The taxpayer issued to the broker an order to use the last-in, first-out method. The taxpayer gave this order to his broker on April 15, 2014. How will the taxpayer's basis in the shares be determined?

   a. Basis will be determined per taxpayer's request using the shares that were acquired last (last-in, first-out).
   b. Basis will be determined using the specific-identification method.
   c. Basis will be determined using the shares that were acquired first (first-in,-first out).
   d. Basis will be determined using the average cost method.

9. A taxpayer has several brokerage accounts in which hundreds of stock trades were executed for the tax year. Which of the following violates the reporting requirements of Form 8949?

   a. The taxpayer may report the totals from each broker and account on a separate line of Form 8949, enter "information available upon request," and e-file the return.
   b. Taxpayer may report the totals from each broker and account on a separate line of Form 8949, and e-file the tax return. Copies of the brokerage statements showing the detailed transactions should be attached to Form 8453 and mailed to the IRS.
   c. Taxpayer may enter each individual transaction reported on all Forms 1099-B, on Forms 8949, and e-file the tax return.
   d. Taxpayer may report the totals from each broker or account on a separate line of Form 8949, and attach the statements to a paper-filed tax return.

10. A taxpayer in 2012 was married and had an AGI of $173,000. The 2014 monthly Medicare Part D surcharge is:

   a. $272.70.
   b. $146.90.
   c. $ 31.10.
   d. $ 12.10.

11. A U.S. citizen who is a bona fide resident of a foreign country has had to return to the U.S. due to adverse conditions existing in that foreign county. The taxpayer is eligible for a waiver from the tests to exclude foreign earned income and housing costs:

    a. The taxpayer would have otherwise met the 330-day physical presence test.
    b. The taxpayer maintained a tax home both in the foreign country and the U.S.
    c. The foreign country is included on the Secretary's list of foreign countries for purposes of §911(d)(4)(B).
    d. The taxpayer was unable to safely stay in the foreign country.

12. Who is required to file Form 8938, Statement of Specified Foreign Financial Assets?

    a. A married filing jointly taxpayer living in the U.S. with total value of foreign financial assets of $165,000 at the end of the year.
    b. A U.S. corporation with total value of foreign financial assets of $325,000 at the end of the year.
    c. A 13-year-old child who has no income tax filing requirement, but has a non-interest foreign checking account valued at $15,000 at the end of year for use when visiting relatives in the foreign country.
    d. A single taxpayer living in Hong Kong with total value of foreign financial assets of $175,000 at the end of the year.

13. A U.S. taxpayer has three financial accounts in the British Isle of Guernsey with combined high balances during the calendar year of $750,000. The taxpayer has held the accounts for seven years, and has earned significant interest income on these accounts. He has filed a U.S. individual income tax return each year, but has not reported the interest income from these accounts nor has he filed the required FBARs. What is the best recourse for this taxpayer to become compliant with U.S. tax laws?

    a. File amended tax returns for the past three years (while statute of limitations is still open), pay the related tax and interest for previously unreported offshore interest income, and file the required FBARs.
    b. File amended tax returns for the past seven years, pay the related tax and interest for previously unreported offshore interest income, and file the required FBARs.
    c. Leave the prior years' returns as they are, but become compliant in the current year by reporting the interest income and filing the required FBAR.
    d. File amended tax returns for the past seven years, file the required FBARs, and meet the other requirements under the Offshore Voluntary Disclosure Program.

14. Scotts & Co., a UK-based financial institution, has registered online with the IRS to become fully compliant with the requirements of the Foreign Account Tax Compliance Act (FATCA) for foreign financial institutions. A customer of Scotts has refused to indicate on his paperwork whether or not he is a U.S. citizen, and the staff at Scotts has repeatedly asked him to answer the question to no avail. What must Scotts do now?

    a. Withhold and pay to the IRS 30% of U.S. source income to the customer, as well as any gross proceeds from the sale of securities that generate U.S. source income.
    b. Report the customer to the IRS for failing to indicate his status as a U.S. person.
    c. Assess a penalty against the customer equal to 30% of the highest balance of his account during a calendar year.
    d. Inform the customer that he cannot be an account holder at the Scotts & Co. bank.

15. Which statement accurately describes the filing requirements of FBAR Form TD F 90-22.1 and FATCA Form 8938?

    a. Both forms are filed with the taxpayer's tax return by the due date, including extension.
    b. Both forms report the maximum value of the foreign financial account or assets.
    c. Both forms are filed by qualifying U.S. individuals or U.S. entities.
    d. Both forms are required when the aggregate value of accounts or assets exceeds $10,000 at any time during the calendar year.

16. What is the filing requirement for a U.S. person who holds residential real property located in restricted zones in Mexico through a Mexican Land Trust (MLT)?

    a. The requirement is to file Form 3520-MLT, Annual Return to Report Transactions with Mexican Land Trusts.
    b. The requirement is to file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.
    c. There is no requirement to file a Form 3520 because the Mexican Land Trust is a requirement to satisfy Mexican law only.
    d. There is no requirement to file a Form 3520-MLT because the Mexican Land Trust is a requirement to satisfy Mexican law only.

17. A pastor is hired by a small church. By action of the church's three-member personnel committee, the pastor is provided $2,000 per month to rent and furnish a home for himself and his family. The fair rental of the home and furnishings is $17,000. The action of the committee passes by unanimous vote, but the vote is never documented because no one takes minutes in the personnel committee meeting. The signed employment agreement does not designate the rental allowance. How much will be taxable to the pastor as compensation income upon examination by the IRS?

    a. $0.
    b. $7,000.
    c. $17,000.
    d. $24,000.

18. Which of the following would disqualify a disability retirement payment from tax-exempt treatment?

    a. The payment was received under a worker's compensation plan.
    b. The payment was received through a lawsuit or a settlement based on a tort-like claim.
    c. The payment was calculated based on the number of years employed.
    d. The payment was calculated based on the nature of the injury.

19. What is the 2014 regular contribution limit for a family health savings account?

    a. $ 1,000.
    b. $ 2,500.
    c. $ 6,550.
    d. $12,700.

20. For 2014, what is the additional standard deduction for a taxpayer who is both blind and elderly?

    a. $ 1,500.
    b. $ 1,550.
    c. $ 3,000.
    d. $ 3,100.

21. Which standard mileage rate did not change from 2013 to 2014?

    a. Medical and moving.
    b. Charity.
    c. Business.
    d. Employee.

22. A taxpayer makes a cash donation to a charity in the amount of $1,100. This taxpayer has met the required documentation for the deduction of a charitable deduction if he has:

    a. A letter from the charity dated a week after the contribution acknowledging receipt of the donation.
    b. A letter from the charity dated two months after filing his return acknowledging receipt of the donation.
    c. A letter from the charity dated a week after the contribution acknowledging receipt of the donation and stating that no goods and services were received in exchange for the contribution.
    d. A copy of the cancelled check for $1,100 written to the charity.

23. In which of the following situations may a taxpayer's deduction for a casualty or theft loss be **DISALLOWED**?

    a. A hurricane damages a taxpayer's home in 2014, but the full extent of the financial loss is unknown until 2015 when the final insurance reimbursement is received. The taxpayer takes the casualty loss (total damage less insurance reimbursement) in 2015.
    b. An employee steals $10,000 from an employer in 2014 is caught immediately and fired. The employee promises to repay the employer the full $10,000 in 2015. When the employer does not receive the payment in 2015, he takes a theft loss on his 2015 tax return.
    c. A homeowner sues the city for damages that were inflicted on their home by a broken water main in 2014. The lawsuit is pending at the end of 2014 and no determination can be reasonably made as to whether the taxpayer will receive any reimbursement in 2015. The taxpayer deducts the casualty loss in 2014.
    d. A taxpayer pays kidnapping ransom payments in 2014. He takes a theft loss in 2014.

24. A single taxpayer has a modified adjusted gross income in 2014 of $175,000. He realized a $40,000 capital gain from the sale of undeveloped land. The taxpayer, using the installment method of recognizing the gain, will recognize $4,000 of capital gain in 2014. The taxpayer also has gain from the sale of a vehicle used in his trade or business of $5,000. What amount of income will be subject to the 3.8% Medicare tax in 2014?

    a. $0.
    b. $4,000.
    c. $9,000.
    d. $40,000.

25. A(n) _______ system of taxation means the income tax laws are generally identical to the United States Internal Revenue Code.

    a. Reciprocity code.
    b. Identic code.
    c. Mirror code.
    d. Equivalent code.

26. A married filing separately taxpayer has the following income and expense items for the tax year. The taxpayer's modified adjusted gross income (MAGI) is $220,000. What is the taxpayer's net investment income?

Income items:	
Interest income from savings accounts	$400
Interest income from municipal bonds	$400
Dividends	$400
Oil and gas royalties	$700
Rental income from office building	$2,000
Income from publicly traded partnership	$200
Capital gain from sales of securities	$400
S Corporation income from childcare business	$20,000
Gain on sale of principal residence	$30,000
Expense items:	
Cost depletion	$100
Rental expenses from office building	$1,000
Margin interest expense	$(100)

a. $2,900.
b. $3,300.
c. $32,900.
d. $33,300.

27. An individual indirectly owns a passive business through a partnership. The determination of whether the gross income from the partnership is excluded from net investment income is made at the _______level.

a. Individual.
b. Pass through.
c. Entity.
d. Owner.

28. Income from an equipment leasing activity that averages less than seven days of customer use of equipment and more than 500 hours of owner participation in the business is considered:

a. Passive income.
b. Non-passive trade or business income.
c. Rental income.
d. Net investment income.

29. Which of the following factors is irrelevant in determining whether a real estate rental activity is a business activity or a passive activity for purposes of the NII:

    a. The type of property.
    b. The type of lease.
    c. The number of properties rented.
    d. The location of the property.

30. Assuming that a taxpayer is subject to the 3.8% Medicare tax, what is net investment income in the following example?

Dividends and interest	$10,000
Capital gain from sale of land	$20,000
Capital loss from sale of stock	$(10,000)
Capital loss carryover from prior tax year	$(7,000)
Gain from sale of property held in a business	$15,000

    a. $13,000.
    b. $20,000.
    c. $28,000.
    d. $45,000.

31. On July 14, 2012, an interest in an S corporation was disposed of in an IRC Section 453 installment sale, which provided that the gain would be recognized on the tax return equally over the next 15 years. What step must be taken in order for the post-December 31, 2012 installment rules to apply in the net gain calculation for NII purposes?

    a. In 2013, the taxpayer must attach an IRS- required statement of adjustment that shows the installment sale calculation.
    b. In 2013, the taxpayer should re-calculate the gain or loss adjustment using the post-January 1, 2013 rules.
    c. The taxpayer must amend the 2011 and 2012 tax returns to retroactively apply the post-December 31, 2012 installment rules to the net gain calculation.
    d. In 2013, the taxpayer must make an irrevocable election (evidenced by a computational statement found at IRC Section 1.1411-7(d)) to have the post-December 31, 2012 installment sale rules apply.

32. Which of these expenses is excluded from the computation of net investment income?

    a. Margin interest expense.
    b. Brokerage fees.
    c. Unreimbursed employee expenses.
    d. State income tax allocable to dividends.

33. Which of the following statements accurately reflects the limitations on itemized deductions in the computation of net investment income (NII)?

    a. The 2% floor on miscellaneous itemized deductions and the overall limitation on itemized deductions are both ignored in the calculation of NII.
    b. The 2% floor on miscellaneous itemized deductions is included in the computation of NII, but the overall limitation on itemized deductions is ignored.
    c. The 2% floor on miscellaneous itemized deductions is ignored in the computation of NII, but the 2% floor on miscellaneous itemized deductions is included.
    d. The 2% floor on miscellaneous itemized deductions and the overall limitation on itemized deductions are both included in the calculation of NII.

34. Which of the following is a prohibited deduction in the calculation of net investment income?

    a. Suspended passive losses from a prior passive activity.
    b. Contributions to IRAs.
    c. Unrecovered basis in an annuity.
    d. Estate taxes imposed on Income in Respect of Decedent (IRD).

35. Which tax planning idea could be used to reduce the 3.8% Medicare tax on investment income?

    a. Reduce tax-exempt and municipal bond income.
    b. Reduce limited partnership income.
    c. Reduce retirement plan distributions.
    d. Increase rental real estate income.

36. An individual has a low enough income for the year that filing an income tax return is not required. What does the taxpayer need to do to claim exemption from the individual shared responsibility payment provision?

    a. In order to claim exemption from the shared responsibility provision, the taxpayer must file a tax return.
    b. The taxpayer must complete an exemption form made available through the exchange to notify the treasury of eligibility for exemption from the shared responsibility provision.
    c. The taxpayer is not exempt from the shared responsibility payment provision and must file a tax return to make the payment.
    d. The taxpayer is not required to file a tax return for the year, and no action is needed to secure the exemption from the shared responsibility provision.

37. If an individual is enrolled in an eligible employer-sponsored health plan that was in effect on March 23, 2010, what action must this individual take to ensure that this plan meets the minimum essential health coverage requirements?

    a. No action is necessary; the individual may keep the health plan that was in effect on March 23, 2010.
    b. The taxpayer must register through the exchange to re-enroll in the employer-sponsored plan.
    c. The taxpayer must complete an employer-provided form to re-enroll in the employer-sponsored plan.
    d. The taxpayer cannot continue on the employer-sponsored plan, but must enroll in one of the plans provided by the exchange.

38. If an employee, or relative of an employee, is eligible for minimum essential health coverage under an employer-sponsored plan, only the _______ of the employer's plan determines if the individual lacks affordable coverage.

    a. Eligibility.
    b. Compliance.
    c. Cost.
    d. Size.

39. What is the flat fee households are required to pay for the 2014 shared responsibility penalty?

    a. $ 0.
    b. $ 95.
    c. $325.
    d. $695.

40. Which statement is true regarding a distribution from an HSA or MSA?

    a. Withdrawals not used for qualified medical expenses are included in net investment income.
    b. The Affordable Care Act increased the penalty on unqualified distributions to 20%.
    c. The maximum distribution from an HSA or MSA for any given year is $12,500.
    d. The 10% penalty on unqualified distributions cannot be waived.

41. Which AMT preference or adjustment item impacts the most taxpayers?

    a. Regular tax net operating losses.
    b. Personal exemptions and standard deductions.
    c. State and local tax deductions.
    d. Passive activity losses.

42. Which action is poor tax planning with respect to the 2014 kiddie tax?

a. Investing in growth stock rather than stock paying dividends.
b. Investing in tax exempt bonds.
c. Moving custodial bank accounts into a §529 plan for the child.
d. Selling a child's stock that is producing gains.

43. A taxpayer has the following circumstances:

- He is married and files a joint return with his spouse
- He is a U.S. citizen and his wife is a lawful alien in the U.S.
- He and his wife have two children
- He and his wife earn $75,600 each year
- His employer offers minimum essential health care coverage
- He has enrolled in a qualified health insurance through an exchange

This taxpayer is exempt from receiving a health insurance premium assistance refundable credit because:

a. He is eligible for minimum essential health coverage through his employer.
b. He has enrolled in qualified health insurance through an Exchange.
c. His wife is not a U.S. citizen.
d. His income is not between 100% and 400% of the Federal poverty line for his family size.

44. Beginning in 2014, a single taxpayer who earns $50,000 per year enrolls in a post-graduate program to earn a Master's degree in Business Administration. The taxpayer incurs expenses for tuition and fees, along with course materials required for enrollment. The taxpayer will be pursuing this program in the evening, taking only six hours per semester. Which credit or deduction would the taxpayer use to claim tax benefit for these expenses?

a. Lifetime Learning Tax Credit.
b. Higher Education Tuition Deduction.
c. American Opportunity (Hope) Tax Credit.
d. The combination of the Lifetime Learning Tax Credit with the Higher Education Tuition Deduction.

45. Which of the following statements reflects the new proposed regulations for Earned Income Tax Credit (EITC) in 2013?

    a. For families with three or more children, the EITC is 40% of the family's qualifying earned income.
    b. Paid tax return preparers are required to file the due diligence checklist, Form 8867, with any federal return claiming the EITC.
    c. The EITC is allowed if the taxpayer has disqualified income in excess of $3,300 for the taxable year.
    d. The minimum EITC is $6,044 for married filing joint taxpayers with three children.

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5.	___	14.	___	23.	___	32.	___	41.	___
6.	___	15.	___	24.	___	33.	___	42.	___
7.	___	16.	___	25.	___	34.	___	43.	___
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2014 Individual & Employee Federal Tax Update
Course #8142389, Version 1403

Please evaluate the following items (Circle the appropriate numbers or items):

	Excellent	Good	Average	Below Average	Poor
Learning objectives met	5	4	3	2	1
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Content relevant to learning objectives	5	4	3	2	1
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Prerequisites were appropriate?	yes	no			
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