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Five-Minute Tax Briefing®

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Highlights

Final Regulations Ease Circular 230 Requirements on Written Advice: The final regulations (TD 9668), which affect individuals who practice before the IRS, remove the IRS's separate rules under Circular 230 regarding "covered opinions." They adopt the approach taken in the proposed regulations, eliminating the covered opinion rules in former section 10.35 and, instead, subject all written tax advice to one standard under final section 10.37. According to the Treasury, the rules in the final regulations are intended to eliminate the need for unnecessary disclaimers in email and other writings, which can be misleading when overused. The regulations are effective on 6/12/14.

No Bankruptcy Protection for Inherited IRAs: In resolving split decisions between the Fifth and Seventh Circuits, the U.S. Supreme Court unanimously held that funds in an inherited IRA aren't considered "retirement funds" as defined by the Bankruptcy Code and, thus, aren't exempt from the bankruptcy estate. Although the Bankruptcy Code allows a debtor to exempt "retirement funds" (i.e., give creditor protection) that are exempt from income tax, the Court concluded that inherited IRAs don't have the same characteristics as other types of IRAs, such as traditional and Roth IRAs. According to the Court's reasoning, individuals who hold inherited IRAs (1) can't contribute additional money in those accounts, (2) are required to make withdrawals regardless of how many years away from retirement they are, and (3) can withdraw the entire balance at any time for any purpose without triggering the 10% early withdrawal penalty under IRC Sec. 72(t). The Court considered these characteristics more like a "pot of money that can be freely used for current consumption," rather than retirement funds set aside for the time the individual stops working. Thus, the Court denied bankruptcy exemption, affirming the Seventh Circuit 2013 opinion. Clark v. Rameker, 113 AFTR 2d 2014-2308 (S. Ct.), *aff'g* 714 F.3d 559, 111 AFTR 2d 2013-2482 (7th Cir.).

Portability Election Allowed Despite Late-filed Estate Tax Return: An executor can elect to transfer the decedent's unused basic estate tax exclusion amount to the surviving spouse and, thus, avoid wasting that amount. This is referred to as the portability election and is made by timely filing an estate tax return (Form 706, even if a return would not otherwise be required. In this ruling, the executor didn't file Form 706 because the value of the decedent's estate was less than the basic exclusion amount. Upon realizing the return should have been filed to make the portability election, the executor requested an extension of time to file. In its analysis, the IRS distinguished between statutory and regulatory elections, concluding that the portability election for estates not otherwise required to file an estate tax return is a regulatory election. Thus, the IRS had discretionary authority under Reg. 301.9100-3 to grant an extension of time to elect portability. If the estate had been required to file an estate tax return under IRC Sec. 6018 (because the estate value exceeded the basic exclusion amount), the portability election would have been a statutory election, and the IRS would not have authority to extend the time for filing the return. [**Editor's Note:** Rev. Proc. 2014-18 allows an extension of time to elect portability, but only for estates of decedents who died in 2011, 2012, and 2013 that were not otherwise required to file.] Ltr. Rul. 201421002.

Taxpayer Bill of Rights: The IRS has adopted a "Taxpayer Bill of Rights" to provide taxpayers with a better understanding of their rights on such issues as audits and collection. Although the tax code includes numerous taxpayer rights, they're scattered throughout the code, making them difficult to track and understand. The Taxpayer Bill of Rights uses these existing rights and groups them into 10 broad categories, which will make it easier for taxpayers to find on the IRS website (**www.irs.gov**). IRS Publication 1, *Your Rights as a Taxpayer*, has been updated with the 10 rights and will be sent to millions of taxpayers this year when they receive IRS notices. News Release IR-2014-72.

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Other Current Releases

Applicable Federal Rates for July: The Section 7520 rate for July 2014 is 2.2%, while the Applicable Federal Rates (AFRs) are as follows (Rev. Rul. 2014-20, 2014-28 IRB):

	Annual	Semiannual	Quarterly	Monthly
Short-term (≤ 3 years)	0.31%	0.31%	0.31%	0.31%
Mid-term (> 3 years but ≤ 9 years)	1.82%	1.81%	1.81%	1.80%
Long-term (> 9 years)	3.06%	3.04%	3.03%	3.02%

Health Care—Inconsistencies Delay Health Insurance Marketplace Processing: If information provided with Marketplace applications was missing or doesn't match that found in other records, applicants will receive follow-up information requests. A new discussion was added to the website on 6/4/14, titled "How do I resolve an inconsistency?" at **https://www.healthcare.gov/help/how-do-i-resolve-an-inconsistency/**. The discussion provides a list of documents that can be submitted to rectify an inconsistency, including documents related to immigration status, veteran status, income, incarceration, Indian status, employer-sponsored coverage, residency, Social Security number, and identity. The requested information should be provided as soon as possible to prevent interruption of coverage or any subsidies.

Income Tax—Calendar Notes Not Enough to Substantiate Vehicle Expenses: A taxpayer, who was employed as an outside direct sales representative, used his truck to call upon customers. Per company policy, he wasn't reimbursed for his expenses. To keep track of his truck expenses, he kept records in a calendar planner book by documenting his truck's odometer readings at the beginning and end of each month, but no other information related to vehicle usage (personal or business) was included. On his Schedule A for the year, the taxpayer claimed a deduction of over $20,000 in vehicle expenses, based on the standard mileage rate, which the IRS disallowed for lack of substantiation. The Tax Court agreed with the IRS, concluding that although the taxpayer had unreimbursed travel expenses related to his employment, he failed to follow the strict substantiation requirements of IRC Sec. 274(d). The taxpayer's calendar, while contemporaneous, did not sufficiently document the business purpose of each business use of his truck. *David H. Garza*, TC Memo 2014-121 (Tax Ct.).

Income Tax—Disputed Foreclosure Delays Freeing up of Suspended Passive Losses: A husband and wife owned two rental condos that generated nondeductible passive losses. When their mortgage company filed a lawsuit to foreclose on the properties, the couple disputed the amount owed. Although the condos were sold upon foreclosure, the dispute over how much the mortgage company was owed continued for several more years. At the time of the sale, the mortgage company issued Forms 1099-A (Acquisition or Abandonment of Secured Property), reporting the balance due on the mortgages and the fair market values of the properties. The couple deducted the suspended passive losses in the year of sale, claiming the sale was a complete disposition of the passive activity. However, the Tax Court disagreed, concluding that the sale was not a complete disposition of the owner's interest in the condos because the parties were still litigating, and a final gain or loss realized on disposition of the property could not be determined at the time of the sale. Thus, the suspended losses could

not be deducted as nonpassive losses until the litigation had been resolved, and accuracy penalties applied. *Alexander Herwig*, TC Memo 2014-95 (Tax Ct.).

Income Tax—Foreclosure of Passive Activity Frees up Suspended Losses: The Office of Chief Counsel issued a memo advising that foreclosure of real estate subject to recourse debt comprising the taxpayer's entire interest in the activity qualifies as a fully taxable transaction and, thus, triggers the recognition of any suspended passive activity losses from the activity. The losses are treated as nonpassive under IRC Sec. 469(g)(1)(A), regardless of whether any Cancellation of Debt (COD) income is excluded under IRC Sec. 108(a)(1)(B). The nonpassive losses are not reduced by any excluded COD income. CCA 201415002.

Income Tax—Injunction against Fraudulent Minister Upheld: The 10th Circuit Court of Appeals upheld the IRS's injunction under IRC Sec. 7408 against the head minister of the Church of Compassionate Service who recruited individuals to be "ministers of the church" using a scheme by which the recruits/ministers didn't pay income tax. At the time of the court proceedings, the church had approximately 50 active ministers. The ministers took vows of obedience and poverty transferring their property and income earned from outside employment to the church which, in turn, paid the mortgages on their homes (now parsonages) plus their living and other expenses. *Kevin Hartshorn*, 113 AFTR 2d 2014-2293 (10th Cir.).

Income Tax—IRA Withdrawal to Buy Real Estate Was a Taxable Distribution: In a recent Tax Court case, the taxpayer found a piece of undeveloped land he wanted to purchase through his self-directed IRA at Schwab. After conducting some internet research, he concluded that IRAs are permitted to hold real property for investment. However, Schwab did not allow such alternative investments, therefore, he purchased the property for the IRA by completing a withdrawal form for $114,000 from the IRA and had the funds wired to the bank handling the purchase. Schwab issued a Form 1099-R reporting the $114,000 distribution that indicated no exception to the early distribution penalty applied. The taxpayer argued that the $114,000 withdrawal wasn't taxable because it was either (1) a purchase made by the IRA, or (2) a trustee to trustee transfer. The Court sided with the IRS concluding that the IRA didn't purchase the property noting that Schwab's policies didn't permit IRAs to hold real property. [**Editor's Note:** It didn't help the taxpayer that the land had been titled in his name instead of the IRA's name.] The distribution was taxable and subject to the 10% early withdrawal penalty under IRC Sec. 72(t). *Guy M. Dabney*, TC Memo 2014-108 (Tax Ct.).

Income Tax—Lease Termination Payment Made When Property Purchased Was Deductible: The Sixth Circuit Court of Appeals recently examined a case in which a lessee, who bought a leased property from the lessor for a price greater than the value of the property, immediately deducted as a business expense the portion of the purchase price it paid to buy the unexpired lease. The issue considered was whether the termination payment could be deducted or must it be capitalized in the property's purchase price. The corporation (ABC) exercised an option to buy property that it was leasing after determining the lease was too high. Appraisals valued the property without the lease at $2.75 million, and ABC determined that the fair market value of the property with the lease would be at least $9 million and bought the property for more than $9 million. ABC reported $2.75 million as the property's cost and deducted $6.25 ($9−$2.75) million as a lease termination expense on its tax return. The IRS disallowed the deduction assessing a deficiency. On summary judgment, the District Court held that ABC should have been allowed the deduction relying on precedent of *Cleveland Allerton Hotel* [36 AFTR 862 (6th Cir., 1948)] while noting that subsequently enacted IRC Sec. 167(c)(2) does not prohibit deducting the lease expense. *ABC Beverage Corporation*, 113 AFTR 2d 2014-XXXX (6th Cir.).

Income Tax—No Goodwill Transfer between Father's Former and Sons' New Businesses: A taxpayer who wholly-owned his trucking corporation ceased operations due to negative attention and possibility of shutdown after being charged with regulatory infractions. However, the corporation remained a viable entity with over $260,000 in assets, including accounts receivables, which it continued to collect. The taxpayer's three sons, who weren't previously involved with the trucking company, started their own trucking business, performing some of the same services and employing many of the same employees. However, nothing was transferred from the father's corporation to the sons' new company. Instead, the sons' trucking company provided a wider range of services, and obtained its own licenses, regulatory authorizations, suppliers, and customers. The IRS assessed tax and penalties on the father, based on its position that the corporation had made a taxable distribution of goodwill to the father, which he then gifted

to his sons. The Tax Court disagreed, concluding that due to various regulatory infractions, the father's corporation had lost most of any goodwill it may have once had and might have been a detriment. Thus, there was no taxable distribution or gift of goodwill. *Bross Trucking, Inc.*, TC Memo 2014-107 (Tax Ct.).

Income Tax—Surviving Spouse Can Rollover Deceased Husband's Roth IRA Despite Trust Beneficiary: Taxpayers cannot rollover inherited IRAs (including Roth IRAs) to their own IRAs [IRC Sec. 408(d)(3)]. An inherited IRA is generally any IRA acquired by reason of the IRA owner's death. However, under the spousal exception, an IRA is not an inherited IRA if the surviving spouse is the IRA's sole beneficiary with unlimited rights of withdrawal. This spousal exception does not apply if the IRA's beneficiary is a trust, even if the spouse is the trust's sole beneficiary, unless the surviving spouse has the sole authority and discretion under trust language to pay the IRA proceeds to himself or herself. The IRS ruled that the surviving spouse, who was the subject of the ruling, met this latter exception. Although the beneficiary of the decedent's Roth IRA was a trust, the surviving spouse was the trust's sole beneficiary and sole trustee with power to distribute the IRA to herself. Therefore, the spousal exception applied and the surviving spouse could rollover the decedent's Roth IRA to a Roth IRA set up and maintained in her name. Ltr. Rul. 201423043.

Income Tax—Taxpayer Loses on 1031 Treatment and Basis Calculation: One of the many requirements to qualify for a nonsimultaneous (deferred) like-kind exchange under IRC Sec. 1031 is that a Qualified Intermediary (QI) must be used in the transactions. Only certain persons qualify as a QI and the taxpayer's agents and family members (including ancestors and lineal descendants) are disqualified [Reg. 1.1031(k)-1(k)]. In a recent Tax Court case, a taxpayer used his attorney son as his intermediary. The Court held that the son was a disqualified person and that the regulations made no exception based on his profession. In addition, the taxpayer unsuccessfully argued that his basis in the property being exchanged included the original cost basis ($488,000) and additional basis of $580,000 ($500,000 and $80,000 that were paid to former spouses incident to divorce). The Court determined that the transfers incident to divorce were gifts and that the transferee does not acquire a basis in the transferred property equal to the transferee's cost [Temp. Reg. 1.1041-1T(d), Q&A 11]. Consequently, the taxpayer could not increase his basis in the property by the divorce settlement payments ($580,000). *Frank J. Blangiardo*, TC Memo 2014-110 (Tax Ct.).

Procedure—Court Says IRS Must Prove Fraud for Section 6701 Penalty Assessment: The standard to be applied in assessing the Section 6701 penalty for adding and abetting the understatement of tax liability was recently at issue on appeal. The case involved a Jackson Hewitt tax preparer (Carlson) whom IRS examiners found had prepared 40 income tax returns with unsubstantiated deductions. Carlson paid 15% of the penalties assessed, filed for a refund (which the IRS denied), and sued for refund in district court. The District Court held that the IRS's burden of proof was a preponderance of the evidence, despite Carlson's arguments that the correct standard of proof was clear and convincing evidence (the fraud standard for civil cases). Agreeing with the taxpayer, the 11th Circuit Court of Appeals determined that the IRS must prove fraud to assess a Section 6701 penalty; thus, the burden of proof was clear and convincing evidence. This decision contradicts Second and Eighth Circuit previous holdings that the standard of proof is by a preponderance of evidence. Frances Carlson, 113 AFTR 2d 2014-XXXX (11th Cir.).

Procedure—Regulations Released on Form 5472 Reporting for Foreign Entities: The IRS released final and proposed regulations easing the reporting requirement for filing Form 5472. The proposed regulations (REG-114942-14) remove the current provision for timely filing of Form 5472 separately from an income tax return that is untimely filed. This will result in Form 5472 only being required to be filed with the filer's income tax return for the table year by the due date of the return (including extensions). The proposed regulations will be effective when published as final. The final regulations (TD 9667) implement a 2011 proposed rule, generally eliminating the need for duplicate filing (whether the taxpayer files his income tax return in paper or electronically). The final regulations are effective 6/6/14.

National Tax Advisory®

TO: **All Professional Tax Personnel** **NTA-879**
FROM: **Robin Tuttle Christian, CPA** **DATE:** **June 24, 2014**

RE: **IRS Provides Late Filing Penalty Relief for One-participant Retirement Plans**

Background

The IRS has established a one-year pilot program to provide penalty relief for one-participant retirement plans that have failed to timely file Form 5500-EZ [Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan] or 5500-SF (Short Form Annual Return/Report of Small Employee Benefit Plan). Without this relief, delinquent filers potentially face penalties of $25 per day the failure continues, up to $15,000 per return [IRC Sec. 6652(e)].

Note: One-participant plans that are required to file an annual report typically use Form 5500-EZ, but they can generally use Form 5500-SF if they prefer. For this discussion, we'll refer to Form 5500-EZ. However, the same rules would apply to a plan that chooses to use Form 5500-SF.

A *one-participant plan* is a qualified retirement plan that covers only the business owner and the owner's spouse or one or more partners (or partners and their spouses) in a business partnership. These plans are not "ERISA plans" because they don't cover any common law employees and, thus, are not subject to oversight by the DOL. As such, their annual filing requirements are much less onerous than those for other qualified plans. In fact, many one-participant plans aren't required to file an annual report thanks to a very generous filing exemption. But here's the rub—the plan's exemption status needs to be reassessed every year because things change and if no return is filed in one year (because it's not required) it's all that much easier to overlook a filing requirement in a future year when it is required.

With the filing deadline for calendar-year plans just around the corner, we thought it was a good time to go over the filing requirements for one-participant plans, as well as this new penalty relief pilot program.

Note: The IRS's penalty relief program also applies to certain foreign plans. See Rev. Proc. 2014-32 for further guidance. Also, other qualified retirement plans (i.e., those subject to ERISA) can use the DOL's Delinquent Filer Voluntary Compliance Program (DFVCP) to file late Forms 5500 or 5500-SF. In this case, the plan will pay reduced DOL late filing penalties, but no IRS late filing penalties will be accessed. See IRS Notice 2014-35.

Filing Exemption for One-participant Plans with $250,000 or Less in Assets

One-participant plans are generally not required to file Form 5500-EZ (except for the final plan year) if the total of the plan's assets and the assets of all other one-participant plans maintained by the employer do not exceed $250,000 at the end of the plan year.

Plans for which a Form 5500-EZ was previously required to be filed will not need to continue filing the Form 5500-EZ unless their total plan assets (for one or more plans) exceed $250,000 at the close of the plan

year. However, all one-participant plans are required to file Form 5500-EZ for the plan's final year showing that all assets have been distributed.

Practice Tip: Since plans with assets of $250,000 or less at year-end do not have to file an annual report, this can create situations where the plan files in one year, but not the next, and then has a filing requirement again in a future year (when the assets increase again above $250,000). It is recommended that the plan continue to file Form 5500-EZ once a filing requirement has begun until a final return is filed. Doing so will decrease the chances of missed filings and late filing penalties.

If the employer has two or more one-participant plans and the total assets of all of the plans are more than $250,000, the employer must file Form 5500-EZ for each plan. Additionally, when determining whether the $250,000 asset limit is exceeded, all plans of the employer are considered, not just plans that qualify to file Form 5500-EZ. For example, Employer X has two plans, Plan A that covers the owner and Plan B that covers the collectively bargained employees where the plan is not a multiemployer plan. Plan A, which is eligible to file Form 5500-EZ, has $100,000 of assets, and Plan B has $190,000 of assets. The employer must file Form 5500-EZ for Plan A, since the combined assets of both plans exceed $250,000.

Due Date for Filing Form 5500-EZ

Form 5500-EZ is required to be filed by the last day of the seventh calendar month after the plan year ends. Thus, for 2013, a calendar-year employee benefit plan must filed by 7/31/14. An extension of time of up to 2½ months will be automatically granted if a properly competed Form 5558 (Application for Extension of Time to File Certain Employee Plan Returns) is filed with the IRS by the normal due date of the return. [See Reg. 1.6081-11.]

The filing deadline is automatically extended (without the need to file Form 5558) to the due date of the plan sponsor's federal income tax return, if all the following conditions are met:

1. The plan year and the plan sponsor's income tax year are the same.

2. The employer has been granted an extension to file its federal income tax return to a date later than the normal due date (not including any extensions provided by Form 5558) for filing Form 5500-EZ.

3. A copy of the extension of time to file the federal income tax return is kept with the plan's records.

   Example: On The Ball, Inc. (OTB), files its federal income tax return on a calendar-year basis. OTB has a one-participant profit-sharing plan (it covers the business's sole employee, George, who owns the business) that is also on a calendar year and has assets of $300,000 at 12/31/13. On 3/15/14, OTB filed Form 7004 to extend the filing of its 2013 income tax return to 9/15/14.

   OTB does not need to take any action to extend its 2013 Form 5500-EZ. It is automatically extended until 9/15/14 because (1) OTB's income tax year and plan year are the same—calendar 2013; (2) OTB is a single employer and has received an extension of time to file its income tax return to 9/15/14; and (3) OTB will keep a copy of the extension for the federal income tax return, Form 7004, with its 2013 Form 5500-EZ records.

   Note: The Form 5500-EZ could have been extended one month longer, to 10/15/14, by filing a Form 5558 no later than 7/31/14. After 7/31/14, that option is no longer available, so the 9/15/14 deadline will apply.

Delinquent Filings

As stated earlier, a one-participant plan that misses a filing deadline is potentially subject to a late filing penalty of $25 per day the failure continues, up to $15,000 per return [IRC Sec. 6652(e)]. However, the penalty will not be imposed if the failure is due to reasonable cause.

Until the new penalty relief pilot program for one-participant plans was established, the plan administrator had to file the delinquent Form 5500-EZ and provide a signed statement explaining why the return was late and requesting that the IRS abate the late filing penalty. While the penalties were often abated, there was no guarantee, plus it took extra effort. The pilot program makes it that much easier to ensure the late filing penalty is excused.

Using the IRS Penalty Relief Pilot Program for One-participant Plans

To request the waiver of late filing penalties under the new IRS penalty relief pilot program for one-participant plans, the plan administrator must file a complete Form 5500-EZand:

- Mark in red letters in the top margin of the first page (above the title of the form) of Form 5500-EZ: "Delinquent return submitted under Rev. Proc. 2014-32, Eligible for Penalty Relief."

- Complete a paper copy of the transmittal schedule provided in Rev. Proc. 2014-32, and attach it to the front of each delinquent return. (The transmittal schedule is reproduced in Appendix 1.)

If a plan has more than one year of delinquent returns, the returns may be included in a single submission. Similarly, delinquent returns for more than one of the employer's plan may be included in a single submission. For example, if an employer maintains a defined contribution plan and a defined benefit plan, and each plan is delinquent for three plan years, all six delinquent returns can be submitted in a single submission. However, all returns must be appropriately marked at the top of page one and a separate transmittal schedule must be attached to the front of each return included in the submission.

The return can't be filed through the DOL's EFAST2 filing system—it must be filed on paper and mailed to the IRS at the applicable address indicated in the transmittal schedule in Appendix 1.

To qualify for relief under this program, the delinquent return must be filed after 6/1/14 and before 6/3/15. Plans that have already had a penalty assessed for a delinquent return aren't eligible for the penalty relief pilot program. They'll have to establish reasonable cause to get out of the penalty.

No penalty or other payment is required to be paid under this pilot program. However, if this temporary pilot program is replaced with a permanent program, a fee or other payment will be required.

Conclusion

Now is a good time to reassess the current and prior year filing requirements for one-participant plans sponsored by your small business clients. Generally, Form 5500-EZ is required for any year that plan assets at the end of the year exceed $250,000, as well as for the plan's final year when all assets have been distributed. If any delinquent returns are discovered, the client has until 6/2/15 (when the pilot program ends) to get them filed without exposure to the onerous late filing penalty.

References:

IRC Sec. 6652(e).
Notice 2014-35, 2014-23 IRB 1072.
Rev. Proc. 2014-32, 2014-23 IRB 1073.

Appendix 1

Rev. Proc. 2014-32 Transmittal Schedule[1]

1. Applicant's Name (Plan Sponsor or Plan Administrator): _____

2. Plan Name: _____

3. Applicant's Address: _____

4. Applicant's Employer Identification Number (EIN): _____

5. Three-digit plan number (PN): _____

6. Plan Year End Date (Enter MM/DD/YYYY) _____

7. Required Form and Filing Address (Check one):

____ A. In accordance with sections 5.02(1)(a) and 5.04 of the revenue procedure, the enclosed version of Form 5500-EZ was required to be filed for the year of delinquency and is being mailed to[2]:

Internal Revenue Service
1973 North Rulon White Blvd.
Ogden, UT 84404

____ B. In accordance with sections 5.02(1)(a) and 5.04 of the revenue procedure, the enclosed version of Form 5500 was required to be filed for the year of delinquency and is being mailed to:

Internal Revenue Service
Employee Plans Delinquent Filer Program
EP Classification
9350 Flair Drive
El Monte, CA 91731-2828

[1] Source: Rev. Proc. 2014-32.
[2] Most one-participant plans will file Form 5500-EZ under this program.

Tax Action Memo®

TAM-1675
June 24, 2014

2014 Midyear Tax Planning Letters for Clients

Type of Clients: Individuals, including small business owners. **Situation:** Clients need to be reminded that tax planning is a year-round process. **Deadline:** During the more-relaxed summer months.	**Tax Action Required:** Use or adapt the sample midyear tax planning letters included with this release. After sending out your letters, follow up with phone calls or emails to get the ball rolling on tax-saving strategies for this year.

Background

In the midst of continued fiscal turbulence, it's more important than ever to cement client relationships by delivering planning strategies that can cut clients' tax bills and increase cash flow. However, your advice is only valuable when it's actually implemented. The slower summer season is a good time to remind clients about the ongoing importance of tax planning while there's still plenty of time to evaluate and implement moves for this year.

Midyear Tax Planning Letters

With the preceding thoughts in mind, this release includes two sample client letters on the subject of midyear tax planning. One version is short and sweet. The other version is longer. Take your pick!

As a subscriber to this newsletter, you may edit and distribute the letter to clients, potential clients, and referral sources as you see fit. However, please remember that the material is copyrighted. You may not use it for any other purpose, such as posting it on a website area available to the public or sharing it with another firm or association of firms of which you're a member. To download the letter, go to **http://ppc.thomsonreuters.com/subscriptions/tabn**. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Sample Client Letters."

Note: For scores of additional planning ideas that may meet some more specific client needs, see *PPC's Guide to Tax Planning for High Income Individuals*, *PPC's Guide to Retirement Planning*, *PPC's Guide to Practical Estate Planning*, and *PPC's Guide to Personal Financial Planning*. For information about these publications and the many others in our product line visit our website or call (800) 431-9025.

Appendix 1

Sample Midyear Tax Planning Letter (Short Version)

To Our Clients and Friends:

The ordinary federal income tax rates for 2014 will be the same as last year: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. For 2014, the top 39.6% rate affects taxpayers with taxable income above $406,750 for singles, $457,600 for married joint-filing couples, $432,200 for heads of households, and $228,800 for married individuals who file separate returns. Higher-income individuals can also be hit by the 0.9% Medicare tax and the 3.8% Net Investment Income Tax (NIIT), which can result in a higher-than-advertised federal tax rate for 2014.

Despite recent tax increases, the current federal income tax environment remains relatively favorable by historical standards. This letter presents some tax planning ideas to consider this summer while you have time to think. Some of the ideas may apply to you, some to family members, and others to your business.

Leverage Standard Deduction by Bunching Deductible Expenditures

Are your 2014 itemized deductions likely to be just under or just over the standard deduction amount? If so, consider the strategy of bunching together expenditures for itemized deduction items every other year, while claiming the standard deduction in the intervening years. The 2014 standard deduction is $12,400 for married joint filers, $6,200 for single filers, and $9,100 for heads of households.

For example, say you're a joint filer whose only itemized deductions are about $4,000 of annual property taxes and about $8,000 of home mortgage interest. If you prepay your 2014 property taxes by December 31 of this year, you could claim $16,000 of itemized deductions on your 2014 return ($4,000 of 2014 property taxes, plus another $4,000 for the 2015 property tax bill, plus the $8,000 of mortgage interest). Next year, you would only have the $8,000 of interest, but you could claim the standard deduction (it will probably be around $12,600 for 2015). Following this strategy will cut your taxable income by a meaningful amount over the two-year period (this year and next). You can repeat the drill all over again in future years. Examples of other deductible items that can be bunched together every other year to lower your taxes include charitable donations and state income tax payments.

Time Investment Gains and Losses

For many individuals, the 2014 federal tax rates on long-term capital gains will be 15%. However, for lower income taxpayers its 0% and the maximum rate for higher-income individuals is 20%. This 20% rate only affects taxpayers with taxable income above $406,750 for singles, $457,600 for married joint-filing couples, $432,200 for heads of households, and $228,800 for married individuals who file separate returns. Higher-income individuals can also be hit by the new 3.8% NIIT on net investment income, which can result in a maximum 23.8% federal income tax rate on long-term capital gains.

As you evaluate investments held in your taxable brokerage firm accounts, consider the tax impact of selling appreciated securities (currently worth more than you paid for them). For most taxpayers, the federal income tax rate on long-term capital gains is still much lower than the rate on short-term gains. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling in order to qualify for the lower long-term gain tax rate.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end may be a good idea as well. The resulting capital losses will offset capital gains from other sales this year, including short-term gains from securities owned for one year or less. For 2014, the maximum rate on short-term gains is 39.6%, and the 3.8% NIIT may apply too, which can result in an effective rate of up to 43.4%. However, you don't have to worry about paying a high rate on short-term gains that can be sheltered with capital losses (you will pay 0% on gains that can be sheltered).

If capital losses for this year exceed capital gains, you will have a net capital loss for 2014. You can use that net capital loss to shelter up to $3,000 of this year's high-taxed ordinary income from salaries, bonuses, self-employment, and so forth ($1,500 if you're married and file separately). Any excess net capital loss is carried forward to next year.

Selling enough loser securities to create a bigger net capital loss that exceeds what you can use this year might make sense. You can carry forward the excess net capital loss to 2015 and beyond and use it to shelter both short-term gains and long-term gains recognized in those years.

Consider Deferring Income

It may be beneficial to defer some taxable income from this year into next year, especially if you expect to be in a lower tax bracket in 2015 or affected by unfavorable phase-out rules that reduce or eliminate various tax breaks (child tax credit, education tax credits, and so forth) in 2014. By deferring income every other year, you may be able to take more advantage of these breaks every other year. For example, if you're in business for yourself and a cash-method taxpayer, you can postpone taxable income by waiting until late in the year to send out some client invoices. That way, you won't receive payment for them until early 2015. You can also postpone taxable income by accelerating some deductible business expenditures into this year. Both moves will defer taxable income from this year until next year.

Don't Overlook Estate Planning

For 2014, the unified federal gift and estate tax exemption is a historically generous $5.34 million, and the federal estate tax rate is a historically reasonable 40%. Even if you already have an estate plan, it may need updating to reflect the current estate and gift tax rules. Also, you may need to make some changes for reasons that have nothing to do with taxes.

Additionally, it's a good time to review beneficiary designations on life insurance and retirement accounts. Changes may be needed it there have been family changes such as divorce, death of a current designated beneficiary, or the birth of a child.

Conclusion

As we said at the beginning, this letter is to get you started thinking about tax planning moves for the rest of this year. Please don't hesitate to contact us if you want more details or would like to schedule a tax planning strategy session.

Best regards,

Appendix 2

Sample Midyear Tax Planning Letter (Long Version)

To Our Clients and Friends:

The ordinary federal income tax rates for 2014 will be the same as last year: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. For 2014, the top 39.6% rate affects taxpayers with taxable income above $406,750 for singles, $457,600 for married joint-filing couples, $432,200 for heads of households, and $228,800 for married individuals who file separate returns. Higher-income individuals can also be hit by the 0.9% Medicare tax and the 3.8% Net Investment Income Tax (NIIT), which can result in a higher-than-advertised federal tax rate for 2014.

Despite recent tax increases, the current federal income tax environment remains relatively favorable by historical standards. This letter presents some tax planning ideas to consider this summer while you have time to think. Some of the ideas may apply to you, some to family members, and others to your business.

Leverage Standard Deduction by Bunching Deductible Expenditures

Are your 2014 itemized deductions likely to be just under or just over the standard deduction amount? If so, consider the strategy of bunching together expenditures for itemized deduction items every other year, while claiming the standard deduction in the intervening years. The 2014 standard deduction is $12,400 for married joint filers, $6,200 for single filers, and $9,100 for heads of households.

For example, say you're a joint filer whose only itemized deductions are about $4,000 of annual property taxes and about $8,000 of home mortgage interest. If you prepay your 2014 property taxes by December 31 of this year, you could claim $16,000 of itemized deductions on your 2014 return ($4,000 of 2014 property taxes, plus another $4,000 for the 2015 property tax bill, plus the $8,000 of mortgage interest). Next year, you would only have the $8,000 of interest, but you could claim the standard deduction (it will probably be around $12,600 for 2015). Following this strategy will cut your taxable income by a meaningful amount over the two-year period (this year and next). You can repeat the drill all over again in future years. Examples of other deductible items that can be bunched together every other year to lower your taxes include charitable donations and state income tax payments.

Take Advantage of 0% Rate on Investment Income

For 2014, the federal income tax rate on long-term capital gains and qualified dividends is 0% when those gains and dividends fall within the 10% or 15% federal income tax rate brackets. This will be the case to the extent your taxable income (including long-term capital gains and qualified dividends) does not exceed $73,800 for married joint-filing couples ($36,900 for singles). While your income may be too high, you may have children, grandchildren, or other loved ones who will be in the bottom two brackets. If so, consider giving them some appreciated stock or mutual fund shares that they can then sell and pay 0% tax on the resulting long-term gains. Gains will be long-term as long as your ownership period plus the gift recipient's ownership period (before he or she sells) equals at least a year and a day.

Giving away stocks that pay dividends is another tax-smart idea. As long as the dividends fall within the gift recipient's 10% or 15% rate bracket, they will be federal-income-tax-free.

Warning: If you give securities to someone who is under age 24, the Kiddie Tax rules could potentially cause some of the resulting capital gains and dividends to be taxed at the parent's higher rates instead of at the gift recipient's lower rates. That would defeat the purpose. Also, if you give away assets worth over $14,000 during 2014 to an individual, it will generally reduce your $5.34 million unified federal gift and estate tax exclusion. However, you and your spouse can together give away up to $28,000 without reducing your respective exclusions.

Time Investment Gains and Losses

For many other individuals, the 2014 federal tax rates on long-term capital gains will be 15%. However, the maximum rate for higher-income individuals is 20%. This 20% rate affects taxpayers with taxable income above $406,750 for singles, $457,600 for married joint-filing couples, $432,200 for heads of households, and $228,800 for married individuals who file separate returns. Higher-income individuals can also be hit by the new 3.8% NIIT on net investment income, which can result in a maximum 23.8% federal income tax rate on long-term capital gains.

As you evaluate investments held in your taxable brokerage firm accounts, consider the tax impact of selling appreciated securities (currently worth more than you paid for them). For most taxpayers, the federal income tax rate on long-term capital gains is still much lower than the rate on short-term gains. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling in order to qualify for the lower long-term gain tax rate.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end may be a good idea as well. The resulting capital losses will offset capital gains from other sales this year, including short-term gains from securities owned for one year or less. For 2014, the maximum rate on short-term gains is 39.6%, and the 3.8% NIIT may apply too, which can result in an effective rate of up to 43.4%. However, you don't have to worry about paying a high rate on short-term gains that can be sheltered with capital losses (you will pay 0% on gains that can be sheltered).

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Invest in Tax-free Securities

The most obvious source of tax-free income is tax-exempt securities, either owned outright or through a mutual fund. Whether these provide a better return than the after-tax return on taxable investments depends on your tax bracket and the market interest rates for tax-exempt investments. With the additional layer of net investment income taxes on higher income taxpayers, this year might be a good time to compare the return on taxable and tax-exempt investments. In some cases, it may be as simple as transferring assets from a taxable to a tax-exempt fund.

Make Sure You Qualify to Exclude Principal Residence Gain

Gains up to $500,000 on the sale of a principal residence are completely tax-free for married couples who file joint returns. A still-generous $250,000 is the limit for singles and married individuals filing a separate

return. To qualify for this break, you normally must have owned and used the house as your principal residence for a total of at least two years in the five-year period prior to the sale. You'll definitely want to take these rules into consideration if you're planning on selling your home.

Sell Loser Shares and Give Away the Resulting Cash; Give Away Winner Shares

Say you want to make some gifts to favorite relatives and/or favorite charities. You can make gifts in conjunction with an overall revamping of your holdings of stocks and equity mutual fund shares held in taxable brokerage firm accounts. Here's how to get the best tax results from your generosity.

Gifts to Relatives. *Do not* give away loser shares (currently worth less than you paid for them). Instead, sell the shares and take advantage of the resulting capital losses. Then, give the cash sales proceeds to the relative. *Do* give away winner shares to relatives. Most likely, they will pay lower tax rates than you would pay if you sold the shares. In fact, relatives who are in the 10% or 15% federal income tax brackets will generally pay a 0% federal tax rate on long-term gains from shares that were held for over a year before being sold. For purposes of meeting the more-than-one-year rule for gifted shares, count your ownership period plus the recipient relative's ownership period, however brief. Even if the shares are held for one year or less before being sold, your relative will probably pay a lower tax rate than you (typically only 10% or 15%). However, beware of one thing before employing this give-away-winner-shares strategy. Gains recognized by a relative who is under age 24 may be taxed at his or her parent's higher rates under the so-called Kiddie Tax rules (contact us if you are concerned about this issue).

Gifts to Charities. The strategies for gifts to relatives work equally well for gifts to IRS-approved charities. Sell loser shares and claim the resulting tax-saving capital loss on your return. Then give the cash sales proceeds to the charity and claim the resulting charitable write-off (assuming you itemize deductions). This strategy results in a double tax benefit (tax-saving capital loss plus tax-saving charitable contribution deduction). With winner shares, give them away to charity instead of giving cash. Here's why. For publicly traded shares that you've owned over a year, your charitable deduction equals the full current market value at the time of the gift. Plus, when you give winner shares away, you walk away from the related capital gains tax. So, this idea is another double tax-saver (you avoid capital gains tax on the winner shares, and you get a tax-saving charitable contribution write-off). Because the charitable organization is tax-exempt, it can sell your donated shares without owing anything to the IRS.

Watch out for Alternative Minimum Tax

The alternative minimum tax (AMT) consequences of all tax planning strategies must be considered before actually making any moves. Because the AMT rules are complicated, you may want our assistance.

Consider Selling Rather Than Trading-in Vehicles Used in Business

Although a vehicle's value typically drops fairly rapidly, the tax rules limit the amount of annual depreciation that can be claimed on most cars and light trucks. Thus, when it's time to replace a vehicle used in your business, it's not unusual for its tax basis to be higher than its value. If you trade the vehicle in on a new one, the undepreciated basis of the old vehicle simply tacks onto the basis of the new one (even though this extra basis generally doesn't generate any additional current depreciation because of the annual depreciation limits). However, if you sell the old vehicle rather than trading it in, any excess of basis over the vehicle's value can be claimed as a deductible loss to the extent of your business use of the vehicle.

Retirement Plans

If your business doesn't offer a retirement plan, now might be the time to take the plunge. Current retirement plan rules allow for significant deductible contributions. Even if your business is only part-time or something you do on the side, contributing to a SEP-IRA or SIMPLE-IRA can enable you to reduce your current tax load while increasing your retirement savings. With a SEP-IRA, you generally can contribute up to 20% of your self-employment earnings, with a maximum contribution of $52,000 for 2014. A SIMPLE-

IRA, on the other hand, allows you to set aside up to $12,000 for 2014 plus an employer match that could potentially be the same amount. In addition, if you're age 50 or older by year-end, you can contribute an additional $2,500 to a SIMPLE-IRA.

Employ Your Child

If you are self-employed, you might want to consider employing your child to work in the business. Doing so has tax benefits in that it shifts income (which is not subject to the Kiddie tax) from you to your child, who normally is in a lower tax bracket or may avoid tax entirely due to the standard deduction. There can also be payroll tax savings since wages paid by sole proprietors to their children age 17 and younger are exempt from both social security and unemployment taxes. Employing your children has the added benefit of providing them with earned income, which enables them to contribute to an IRA. Children with IRAs, particularly Roth IRAs, have a great start on retirement savings since the compounded growth of the funds can be significant.

Remember a couple of things when employing your child. First, the wages paid must be reasonable given the child's age and work skills. Second, if the child is in college or entering soon, too much earned income can have a detrimental impact on the student's need-based financial aid eligibility.

Don't Overlook Estate Planning

For 2014, the unified federal gift and estate tax exemption is a historically generous $5.34 million, and the federal estate tax rate is a historically reasonable 40%. Even if you already have an estate plan, it may need updating to reflect the current estate and gift tax rules. You may need to make some changes for reasons that have nothing to do with taxes as well.

Additionally, it's a good time to review beneficiary designations on life insurance and retirement accounts. Changes may be needed it there have been family changes such as divorce, death of a current designated beneficiary, or the birth of a child.

Conclusion

As we said at the beginning, this letter is to help you begin thinking about tax planning moves for the rest of this year. Please don't hesitate to contact us if you want more details or would like to schedule a tax planning strategy session.

Best regards,

Appendix 3

Practitioner's Reference Sheet for 2014 Midyear Planning Letter

Bunch Deductions: IRC Sec. 63(c).

Capital Gains Tax Rates and Timing of Investment Gains and Losses: IRC Sec. 1(h).

Defer Income: Other ways to defer income include setting up a retirement plan and/or making additional deductible retirement plan or IRA contributions for the year, making like-kind exchanges of appreciated real estate instead of taxable sales, and arranging for installment sales of property.

Invest in Tax-free Securities: TAM-1669,[1] dated 5/13/14.

Make Sure You Qualify to Exclude Principal Residence Gain: IRC Sec. 121.

Gifts to Relatives and Charities: IRC Secs. 1015, 1223(2), and 170(e).

Alternative Minimum Tax: IRC Secs. 55–59.

Retirement Plans: IRC Secs. 404(h), 408(p) and 414(v). Employers must make either matching or nonelective contributions to employee's SIMPLE-IRA accounts. Under the matching alternative, employers must generally match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year. For purposes of the matching contribution, compensation is not limited.

Employ Your Child: IRC Secs. 408, 408A, 3121(b)(3)(A), and 3306(c)(5).

Estate Planning: IRC Secs. 2001, 2010, 2502, 2503, and 2505.

[1] A copy of this article has been placed on PPC's website for the benefit of those who were not subscribers when it was originally published. To retrieve or view the article, go to **http://ppcsrvcs.thomsonreuters.com/subscriptions/tabn**. (Check the top of the first page of the most recent Tax Action Memo you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Articles Mentioned in Previous Issues."

Tax Action Memo®

TAM-1676
June 24, 2014

Update on Tax Implications of Repossessing and Reselling Former Principal Residence

Type of Clients: Individuals who sold a principal residence in a seller-financed deal, repossessed it, and then resold it. **Situation:** Needless to say, this scenario has tax implications. **Deadline:** Before filing returns for the year the resale takes place.	**Tax Action Required:** Read this release to get up to speed on the tax consequences. As illustrated by a recent Tax Court decision, they can be quite favorable, or not, depending on the timing of transactions.

Background

Say your client sold a principal residence for a nice profit a few years ago when the local market was booming and took back a note from the buyer to cover part of the sale price. As you know, this is called a *seller-financed deal*, and they used to be pretty common. Of course, some seller-financed transactions don't work out. If your client's deal blows up, what are the federal income tax implications if the property is repossessed and then resold? Good question. With many residential markets now rebounding, both the financial and tax results from a repossession and resale might be quite favorable. On the other hand, the tax results may be less-than-optimal, depending on the specific circumstances. A controversial new Tax Court decision dramatically illustrates this point, although we think it's wrong. Here's what you need to know.

Federal Income Tax Treatment of Payments Received from Buyer before Repossession

When your client sold the former principal residence the first time, he or she probably collected a down payment and some interest payments on the note before the buyer bailed. The client may have also collected some principal payments if the note called for multiple installments. If the home was sold for a profit, some proportion (the gross profit percentage) of the down payment and principal payments count as potentially taxable gains—based on the gross profit percentage (total gain divided by total sale price).

The client was probably eligible to exclude any such gains, thanks to the Section 121 principal residence gain exclusion (see the discussion later of the Section 121 qualification rules). The gain exclusion allows an unmarried seller to exclude up to $250,000 of otherwise taxable principal residence gain and a married joint-filing couple to exclude up to $500,000.

In any event, the client must report any interest received on the installment note as ordinary income taxed at his or her regular rate.

So far so good, but now the client has repossessed the property and resold it, and there are new tax implications to consider.

The general rule for real estate repossessions, found in IRC Sec. 1038, states that repossessing a property generally triggers taxable capital gain equal to the amount of cash the seller has received from the buyer's down payment and/or principal payments before the repossession, reduced by any gain that was already recognized before the repossession. As mentioned earlier, any interest collected on the note is ordinary income (as opposed to lower-taxed capital gain).

Note: The Section 1038 repossession rules can apply to any sale of real property in which the buyer incurs debt to the seller that is secured by the transferred property. So, the Section 1038 rules can apply to a seller-financed sale where the buyer elects out of installment sale reporting or to a seller-financed sale for a loss. For the full story on the Section 1038 rules, see TAM-1594[1] (dated 3/12/2013).

Special Section 1038(e) Rule

Under IRC Sec. 1038(e), a favorable exception to the aforementioned general rule allows the seller (your client) to use the Section 121 gain exclusion to shelter gain from both the original sale of the former principal residence and the resale after a repossession of the property as long as: (1) the original sale qualified for the gain exclusion privilege and (2) the resale occurs within one year after the repossession date. When those two tests are passed, the seller is allowed to treat the original sale and the subsequent resale as a single aggregated transaction that occurred on the original sale date and that is eligible for the gain exclusion privilege. Except for adding repossession costs to the property's basis in calculating the aggregated gain, the repossession transaction is ignored. Therefore, there is no taxable gain from the repossession transaction itself. As the following example shows, this can lead to very favorable federal income tax results.

Example 1: Special Section 1038(e) rule applies.

Denise and Dave are married joint-filers. On 3/1/08, they sold their former principal residence at the top of the local market for a cool $650,000. The sales proceeds consisted of a $65,000 cash down payment and a $585,000 balloon payment note due on 2/28/14. The note called for monthly interest payments at an adequate rate (at least equal to the AFR at the time). On 2/28/14, the entire $585,000 principal balance was to be repaid.

The sales costs were $30,000 and the tax basis of the property was $220,000. Assuming the buyer would make the $585,000 balloon payment as scheduled, the sale resulted in a potentially taxable gain of $400,000 ($650,000 sale price – $30,000 sales costs – $220,000 basis).

Assume the sale qualified for the $500,000 joint-filer gain exclusion because Denise and Dave had owned and used the property as their principal residence for years. The entire $400,000 profit would have been federal income tax free, so there was no taxable gain on the $65,000 down payment received in 2008, and there would have been no taxable gain if the $585,000 had been collected as scheduled in 2014.

Unfortunately, the buyer made the interest-only payments for five years and a few months and then reneged. On 10/1/13, Denise and Dave repossessed the property after incurring $25,000 in legal fees and other costs.

As luck would have it, the local real estate market experienced a dramatic resurgence, and Denise and Dave were able to resell the property on 3/1/14 for a whopping $750,000 in a conventional sale. Assume they incurred $65,000 of selling costs on the resale.

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[1] A copy of this article has been placed on PPC's website for the benefit of those who were not subscribers when it was originally published. To retrieve or view the article, go to **http://ppcsrvcs.thomsonreuters.com/subscriptions/tabn**. (Check the top of the first page of the most recent Tax Action Memo you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Articles Mentioned in Previous Issues."

Because the original sale qualified for the Section 121 gain exclusion and the resale occurred within one year after the repossession date, Denise and Dave are allowed to treat the two sales as one transaction that took place on the original sale date. Therefore, the gross sales proceeds are $815,000 ($65,000 down payment from the original sale + $750,000 resale price). The total selling costs are $95,000 ($30,000 from the original sale + $65,000 from the resale). Denise and Dave's adjusted tax basis in the property is $245,000 (the original $220,000 plus $25,000 of repossession costs). The recalculated gain on sale is $475,000 ($815,000 gross sales proceeds – $95,000 selling costs – $245,000 basis). The $475,000 gain is entirely federal income tax free because it's completely sheltered by the couple's $500,000 Section 121 gain exclusion. Not bad!

Observation: As you can infer from this example, the obvious purpose behind the special Section 1038(e) rule is to allow the gain exclusion to shelter two gains (up to the applicable Section 121 gain exclusion amount) when both the original sale and the post-repossession resale result in otherwise taxable gains.

Section 121 Gain Exclusion Qualification Rules in a Nutshell

An unmarried seller can exclude (pay no federal income tax on) up to $250,000 of gain, and a married joint-filing couple can exclude up to $500,000. To qualify, both of the following tests must be passed.

- *Ownership Test.* The seller must have owned the property for at least two years during the five-year period ending on the sale date.

- *Use Test.* The seller must have used the property as a principal residence for at least two years during the same five year period (periods of ownership and use need not overlap).

Larger $500,000 Joint-filer Exclusion Test. To be eligible for the maximum $500,000 joint-filer exclusion, at least one spouse must pass the ownership test, and both spouses must pass the use test.

Previous Sale Test. If the seller excluded gain from an earlier principal residence sale under the Section 121 rules, the seller must wait at least two years before taking advantage of the gain exclusion again. If the seller is a married couple filing jointly, the larger $500,000 exclusion is only available if neither spouse claimed the Section 121 exclusion for an earlier sale within two years of the later sale. If either spouse did claim an exclusion during the forbidden two-year period, only the smaller $250,000 gain exclusion is available for the later sale. [See IRC Sec. 121(b)(2).]

Don't Overlook Prorated Exclusion Possibility. If the seller doesn't qualify for the maximum $250,000/$500,000 gain exclusion due to failure to meet all the timing rules, the seller might still qualify for a prorated (reduced) exclusion if the sale was due to: (1) a change in employment, (2) health considerations, or (3) certain unforeseen circumstances specified in IRS guidance. For instance, if the seller is a single individual who used the property as her principal residence for only one year before having to move due to a change in place of employment, she would qualify for a prorated exclusion of $125,000 (half the maximum $250,000 exclusion allowed to unmarried taxpayers). [See IRC Sec. 121(c) and Reg. 1.121-3.]

What If Repossessed Property Is Not Resold Fast Enough?

If the taxpayer fails to resell the property within a year after the repossession date, the original sale and the repossession are treated as two separate transactions, and any resale after the repossession is treated as a third separate transaction. This can lead to less favorable tax results. Assuming the original sale qualified for the gain exclusion, the down payment and any principal payments received before the repossession will usually be fully sheltered by the exclusion. However, the repossession may result in a taxable gain, and a resale after the repossession may result in another gain. For the resale, the Section 121 gain exclusion is only available to the extent the Section 121 qualification rules are met for that transaction. However, according to longstanding guidance in IRS Publication 537 (Installment Sales), this is not as bad as it sounds because the allowable gain exclusion from the original sale reduces the installment sale gross profit

and gross profit percentage, which effectively reduces or eliminates any later repossession gain. Example 2 below illustrates how to calculate the repossession gain and the resale gain (or loss) according to Worksheets D and E in Publication 537. Note that the Code and regulations provide no specific guidance on the Example 2 scenario, so the information in Publication 537, plus a dose of common sense, are basically all we have ever had to go on.

Example 2: Section 1038(e) doesn't apply to resale more than one year after repossession.

Same facts as Example 1, except this time assume the resale date is 11/1/14, which is more than one year after the repossession date. Therefore, the special Section 1038(e) rule is not available. As a result, the original sale, the repossession, and the resale are treated as three separate transactions.

According to the statutory language of Section 121 and the explanation in IRS Publication 537, the tax results from the original 2008 sale are the same as in Example 1: no taxable gain thanks to the Section 121 gain exclusion privilege.

The repossession gain, the tax basis of the repossessed property, and the resale gain/loss are calculated as follows. These calculations are based on a 0% gross profit percentage for the original sale, thanks to the gain exclusion privilege.

Repossession Gain Calculation per Worksheet D in Publication 537

1. Payments received before repossession	$	65,000
2. Gain already reported ($65,000 × 0% gross profit percentage after subtracting gain exclusion from gross profit)	$	0
3. Tentative repossession gain (line 1 – line 2)	$	65,000
4. Gross profit from original sale after subtracting gain exclusion	$	0
5. Repossession costs	$	25,000
6. Add lines 2 and 5	$	25,000
7. Subtract line 6 from line 4 (limited to zero)	$	0
8. Taxable repossession gain (lesser of line 3 or line 7)	$	0

Repossessed Property Basis Calculation per Worksheet E in Publication 537

1. Unpaid balance of note on repossession date	$	585,000
2. Gross profit percentage from original sale after subtracting gain exclusion		0%
3. Unrealized profit (line 1 × line 2)	$	0
4. Adjusted basis in installment note (line 1 – line 3)	$	585,000
5. Taxable repossession gain from Worksheet D	$	0
6. Repossession costs	$	25,000
7. Tax basis of repossessed property (line 4 + line 5 + line 6)	$	610,000

Note: Looking at it another way, the $610,000 basis is comprised of the $220,000 original basis + $30,000 original sales costs + $400,000 excluded gain (which still increases basis) + $25,000 repossession costs – $65,000 down payment already received.

Resale Taxable Gain/Loss Calculation

1. Net sales proceeds ($750,000 – $65,000 selling costs)	$ 685,000
2. Tax basis of property (from above)	$ 610,000
3. Gain on resale (line 1 – line 2)	$ 75,000

The $75,000 resale gain must be reported on Denise and Dave's 2014 Form 1040. The maximum federal rate on 2014 long-term capital gains can be as high as 20%, and Denise and Dave may also get hit with the 3.8% net investment income tax if their income is high enough. Still, this is a decent tax outcome.

Tax Court Says Gain Exclusion Is Disallowed If Repossessed Property Is Not Resold Soon Enough

In its recent *Debough* decision, the Tax Court concluded that a married couple, who sold their principal residence in an installment sale and excluded the gain under Section 121, was ineligible for gain exclusion on the original sale because the property was later repossessed and not resold within one year after the repossession date. As explained earlier, the special Section 1038(e) rule provides that if: (1) Section 1038 applies to a repossession of a residence after a sale for which gain was not recognized due to the Section 121 gain exclusion and (2) the property is resold within one year after the repossession date, the original sale and the resale are treated as a single aggregated transaction occurring on the original sale date, and that transaction is eligible for gain exclusion if the Section 121 qualification rules were met for the original sale. Fair enough.

In *Debough*, however, the IRS went deep into left field by claiming that the general Section 1038 rules for repossessions effectively nullify the Section 121 rules unless the special Section 1038(e) rule applies. In other words, the IRS claimed that if the repossessed property is not resold within one year after the repossession date, the original sale is ineligible for the gain exclusion. Unfortunately, the Tax Court agreed with the IRS interpretation even though it directly conflicts with the government's own longstanding guidance in Publication 537. Here is the rest of the story.

Facts of the Case. In 2006, Marvin Debough and his wife (the taxpayers), sold their principal residence in an installment sale transaction. In 2006–2008, they received payments totaling $505,000 from the buyer and reported $56,920 of taxable installment sale gains. In accordance with the guidance in Publication 537, the taxable installment sale gains were calculated after subtracting the allowable $500,000 Section 121 gain exclusion in determining the installment sale gross profit and gross profit percentage.

Subsequently, the buyer of the property failed to comply with the terms of the deal, and the taxpayers repossessed the property in July 2009. The property was not resold within one year after the repossession date, so the special Section 1038(e) rule did not apply. Pursuant to the general Section 1038 rules explained earlier and illustrated in Example 2, the taxpayers recognized an additional $97,153 of repossession gain in 2009. However, in 2012, the IRS sent them a notice of deficiency for an unreported long-term capital gain amount that was ultimately adjusted to $448,080. That amount equaled the $505,000 of payments received before the repossession minus the $56,920 of gains that had already been reported in 2006–2008. So, the taxpayers were denied any gain exclusion. Seeking justice, they took their case to the Tax Court.

IRS and Taxpayer Positions. The taxpayers and the IRS agreed that the special Section 1038(e) rule did not apply because the property was not resold within one year after the repossession date. The issue was the interplay, if any, between the Section 1038 rules and the Section 121 rules when the special Section 1038(e) rule does not apply. Ignoring Section 121, the general Section 1038 rules require the seller to recognize upon a repossession an amount of taxable gain equal to the down-payment and principal payments received before the repossession minus any installment sale gain already recognized. As stated earlier, the IRS claimed that the general rules of Section 1038 nullify the Section 121 rules, except when the special Section 1038(e) rule applies.

The taxpayers argued that if Congress had intended to completely disallow the Section 121 gain exclusion after a repossession of a principal residence [except when the special Section 1038(e) rule applies], the statutory language would explicitly say so. It does not.

Tax Court's Opinion and Our Opposing View. To make a long story short, the Tax Court opined that the general Section 1038 rules applied in this case, and that the Section 121 gain exclusion was disallowed because the repossessed property was not resold within one year after the repossession date.

We think the Tax Court got it completely wrong. In our view, the taxpayer's original sale clearly qualified for the gain exclusion because all the Section 121 qualification rules were met. After that, it is clear that the repossession transaction fell under the general Section 1038 rules, but the taxpayers should have been allowed to subtract the $500,000 gain exclusion in calculating their taxable repossession gain under the general Section 1038 rules, as illustrated in Example 2. We hope and trust that the taxpayers will appeal the decision.

Conclusion

In *Debough*, the IRS ignored its own longstanding guidance and asked the Tax Court to change the existing pro-taxpayer understanding of the applicable rules without any warning. The IRS did the same thing in the *Bobrow* case. See NTA-868 (dated 2/25/14) and NTA-872 (dated 4/8/14). Folks, this is not a good trend!

References:

IRC Secs. 121 and 1038.
Marvin Debough, 142 TC No. 17 (Tax Ct. 2014).

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

Tax Action Memo®

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Qualified Long-term Care Insurance Offers Tax Advantages

Type of Clients: Middle-aged and older individuals. **Situation:** The client wants to understand the tax rules that apply to long-term care insurance premiums and benefit payments. **Deadline:** N/A.	**Tax Action Required:** Read this to get up to speed on long-term care insurance basics and the tax advantage of qualified long-term care policies.

Background

Long-term care (LTC) insurance coverage is intended to provide the client with some certainty that adequate nursing home and home health care services will be available when needed. Otherwise, the client's assets may be exhausted to pay for these services. (Medicaid also covers these expenses, but only for individuals who have minimal assets and income.) There are also some tax advantages for qualified LTC policies. First, let's cover the basics on the product itself.

Long-term Care Insurance Basics

Like many insurance products, a LTC policy must be purchased before it's really needed. Persons who are already in poor health will find it difficult or impossible to obtain coverage. The following conditions will usually make an individual uninsurable—

- Needs assistance with basic daily living activities (eating, bathing, etc.).
- Already confined to a LTC facility or already receiving LTC services at home.
- Heart attack in the last two years.
- Stroke in the last five years.
- Diagnosed with cancer, Alzheimer's, Parkinson's, or multiple sclerosis.
- Spinal cord injury.
- Organ or bone marrow transplant.

Benefit payments are usually stated as daily or monthly maximums. There may also be a lifetime maximum, which may be stated in terms of dollars or as a number of years that services will be provided (often five or 10 years). Some policies provide equal benefits for nursing home and home care services. Others pay only a percentage (often 60%) of the nursing home maximum for home care services. For an additional premium, most policies will provide automatic inflation adjustments (say 5% per year) to the maximum benefit levels. Inflation protection makes the coverage considerably more expensive.

Some LTC policies charge fixed monthly premiums based on the insured's age when the policy is acquired. However, many policies have premium increases over time. As long the premiums are paid, coverage is assured regardless of changes in health and advancing age.

When the policy is acquired at a relatively young age, the premiums are much lower. This reflects the fact that younger persons are relatively unlikely to need significant LTC services anytime soon. On the other hand, if an individual puts off buying coverage and develops a serious medical condition, he or she may be unable to find an insurer at any price.

Tax Deductions for Qualified LTC Policy Premiums

For federal income tax purposes, a qualified LTC policy is treated as accident and health insurance [IRC Sec. 7702B(a)(1) and (3)]. Benefit payments are tax-free to the insured, within the limits explained below [IRC Sec. 7702B(a)(2) and (d)].

Because a qualified policy is considered to be accident and health insurance, the premiums are considered medical expenses for itemized medical expense deduction purposes. However, annual deductions for the premiums are subject to the age-based limits explained below [IRC Sec. 213(d)(10)]. Premiums (up to the limits) are thrown into the itemized medical expense deduction pot. If the total in the pot exceeds 10% of AGI (or 7.5% of AGI for certain older individuals as explained below), the excess can be written off as an itemized deduction under IRC Sec. 213. An individual's premiums for nonqualified policies are nondeductible [IRC Sec. 213(d)(1)].

For self-employed individuals, 100% of the premiums (subject the age-based limits) can usually be deducted above-the-line as part of the self-employed health insurance deduction [IRC Sec. 162(l)(2)(C)].

For 2014, the age-based premium deduction limits are as follows—

Age on 12/31/14	Maximum Amount Treated as Medical Expense
40 or younger	$ 370
41 to 50	700
51 to 60	1,400
61 to 70	3,720
Over 70	4,660

If an individual receives employer-paid qualified LTC coverage through employment, the cost of coverage is generally a tax-free fringe benefit. However, tax-free treatment doesn't apply when the premiums are paid via a Section 125 cafeteria benefit plan, such as a health care Flexible Spending Account (FSA) plan. In this case, the premiums are considered additional taxable salary. [See IRC Secs. 125(f) and 106(c); the benefit payments themselves are presumably generally tax-free, under the rules explained below.]

Threshold for Itemized Medical Expense Deductions

The old-law 7.5%-of-AGI hurdle for medical expense deductions was hard enough to clear. Now, pursuant to the 2010 healthcare legislation, a stricter 10%-of-AGI threshold applies to most individuals—effective for 2013 and later years. [See IRC Sec. 213(a).]

Exception for 2013. If either the client or the client's spouse was age 65 or older as of 12/31/13, the unfavorable new 10%-of-AGI threshold will not take effect until 2017. Filing a joint return is not necessary to take advantage of this exception based on the age of one's spouse. Until 2017, the familiar 7.5%-of-AGI threshold will continue to apply to folks in this situation. [See IRC Sec. 213(a) and (f).]

Exceptions for 2014 and in the Future. If the client or spouse will turn age 65 in 2014, the new 10%-of-AGI threshold applies for 2013 but not for 2014–2016 (the old-law 7.5%-of-AGI threshold will apply for those years). If client or spouse will turn 65 in 2015, the 10%-of-AGI threshold will apply for 2013 and

2014, but not for 2015 and 2016 (the 7.5%-of-AGI threshold will apply for those years). If client or spouse will turn 65 in 2016, the 10%-of-AGI threshold applies for 2013-2015, but not for 2016 (the old-law 7.5%-of-AGI threshold will apply for that year). [See IRC Sec. 213(a) and (f).] The new 10%-of-AGI threshold applies to everybody after 2016, regardless of age.

Tax Treatment of LTC Benefit Payments

Generally, benefit payments received under a qualified LTC policy are tax-free [IRC Sec. 7702B(a)(2)]. However, some qualified policies pay a designated daily benefit, regardless of actual costs. For 2014, benefits under such per diem policies are automatically tax-free up to $330 per day. When benefit payments exceed the cap, they are still tax-free if actual costs for qualified LTC services equal or exceed the payments. For example, say the policy pays $400 per day regardless of actual expenses. If the insured's actual expenses are $400 or more, there is no taxable income. But if actual expenses are only $300 per day, the insured has $70 per day of taxable income ($400–$330 amount treated as tax-free). Daily benefit payments are automatically tax-free if the insured is terminally ill, as defined by IRC Sec. 101(g)(4).

When benefits are paid during a year, the insured individual should receive a Form 1099-LTC (Long-Term Care and Accelerated Death Benefits*)*, which reports the gross amount of benefit payments. The insured individual then uses Form 8853 (Archer MSAs and Long-Term Care Insurance Contracts) to calculate whether any of the benefits are taxable.

Note: When coverage is not under a qualified policy, the IRS may argue that benefit payments are taxable. That would be very debatable, however, because it seems as if even a nonqualified policy should be considered accident and health insurance—thus, making any benefit payments tax-free to the extent they don't exceed actual LTC costs. [See IRC Sec. 104(a)(3).]

Requirements for Qualified Policies

To qualify for the aforementioned favorable tax treatment, the policy must provide coverage only for qualified LTC services, be guaranteed renewable, and have no cash value. Also, the policy cannot cover expenses eligible for Medicare reimbursement, unless Medicare is a secondary payer, or unless the policy pays a daily benefit without regard to actual expenses.

Qualified LTC services include diagnostic and preventive care, therapy, and rehabilitation. Also included are maintenance and personal care services as long as: (1) the person is chronically ill, and (2) the services are prescribed by a licensed health care practitioner. The tax law definition of chronically ill is based on six activities of daily living (ADL) standards. To be considered chronically ill, the insured person must need assistance in performing at least two of the six ADLs. The six are: (1) eating, (2) toileting, (3) transferring (for example, moving from the bed to a chair), (4) bathing, (5) dressing, and (6) continence. IRC Sec. 7702B describes qualifying policies and LTC services.

Note: Policies with less restrictive conditions for personal care services won't meet the definition of a qualified LTC policy, which makes the premiums nondeductible and the tax treatment of benefit payments problematic. For example, a policy that covers personal care services if the insured is unable to perform any one of the ADLs listed above is not a qualified policy, because a qualified policy can only cover personal care services when the insured is unable to perform two or more ADLs. However, the client may prefer to forego more favorable tax treatment in exchange for more liberal policy terms.

Extra-favorable Tax Treatment for Coverage Provided to Employees

C Corporation Business. If the client runs his or her business as a C corporation, coverage under a company-paid qualified LTC insurance policy can be provided as an employee benefit. It is considered employer-paid accident and health insurance [IRC Sec. 7702B(a)(3)]. As such, it qualifies for the same tax-advantaged treatment as company-paid medical insurance. The corporation can deduct the premiums (without regard to the age-based limits) while the covered employee (including a shareholder-employee) has no taxable income attributable to the company-paid premiums or the receipt of benefit payments under the policy. [See IRC Secs. 7702B(a)(3), 106(a), and 105(b) and (e).] Coverage can be provided for the employee, his or her spouse, and his or her dependents. A dependent can include the employee's parent or grandparent if the employee pays over 50% of the parent's or grandparent's support—even if the parent's or grandparent's gross income is too high for the employee to claim a dependency exemption for the parent or grandparent. [See IRC Sec. 105(b).]

Other Businesses. If the client's business is run as a sole proprietorship, single-member LLC treated as a sole proprietorship for tax purposes, partnership, multimember LLC treated as a partnership for tax purposes, or S corporation, the business can pay the LTC premiums and the client can generally claim above-the-line self-employed health insurance deductions (subject to the age-based limits listed earlier) for LTC coverage for himself, his or her spouse, and his or her dependents (including a dependent parent or grandparent). [See IRC Sec. 162(l)(2)(C) and Rev. Rul. 91-26.]

Even better, when the client's business is run as a sole proprietorship (or single-member LLC treated as a sole proprietorship for tax purposes), it may be possible to deduct 100% of LTC premiums by hiring the spouse as a bona fide employee. The proprietorship (or single-member LLC) can then provide accident and health insurance coverage—including LTC insurance—as a fringe benefit for the employee-spouse. If the employee-spouse then elects family coverage, the business owner (your client) and his or her dependents can also be covered. The coverage is tax-free to the employee-spouse, and so are any benefit payments. The LTC premiums are then written off as a business expense on the owner's Schedule C, E, or F, which reduces both income tax and self-employment tax (when applicable). The IRS admits this all works as we have explained, as long as the value of the insurance coverage and any other compensation delivered to the employee-spouse is reasonable in relation to the services performed. See IRC Secs. 162(a)(1) and 105(b), Rev. Rul. 71-588, TAM 9409006, and IRS Industry Specialized Program Settlement Guideline for Health Insurance Deductibility for Self-Employed Individuals (UIL No. 162.35-02, dated 1/25/01).

Conclusions

For most clients, it's prudent to obtain LTC coverage when they enter the 55-year to 60-year-old age range. For individuals, the tax breaks alone are not sufficient reason to buy a qualified policy. However, they are a bonus when coverage is deemed advisable for general financial planning and asset protection reasons.

On the other hand, when the client owns a business run as a C corporation, sole proprietorship, or single-member LLC, the tax benefits can be substantial. In addition, tax-advantaged coverage can often be provided for the owner's older dependents. In this situation, the tax subsidy provided by Uncle Sam can be a significant inducement to obtain coverage.

References:

IRC Secs. 104, 105, 106, 162, 213, and 7702B.
Rev. Proc. 2013-35 (2013-47 IRB 537).
Rev. Ruls. 71-588 (1971-2 CB 91) and 91-26 (1991-1 CB 184).
IRS Technical Advice Memo (TAM) 9409006.

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.