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Adviser's guide to Innovative tax planning for individuals and sole proprietors

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Tax Planning in an Uncertain Economy

This book presents practical tax planning techniques in several key individual tax areas. The techniques covered here can be applied across a wide range of client income levels. Topic by topic, the book guides you through tax saving techniques and strategies, illustrated by practical examples. Where alternate strategies exist, the book explains the advantages and disadvantages of each so you can assist your clients in making appropriate choices.

The AMT, capital gains, and more. No one can predict with any certainty whether the current individual federal tax rate structure will remain in place. And after repeated changes to the law, the federal income tax rates are more confusing than ever. With proper planning, however, they can also be more beneficial than ever. This book covers what you need to know from both planning and compliance perspectives so you can help your clients maximize their tax savings under the current tax rate structure and plan for the future.

About the Author

Bill Bischoff has 31 years of experience as a tax specialist. He has authored or co-authored dozens of professional publications and hundreds of technical articles for *SmartMoney* and *The Wall Street Journal*, among others.

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William R. Bischoff, CPA, MBA

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AICPA®

William R. Bischoff, CPA, MBA

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Contents

Chapter 1. Maximizing Tax Benefits for Sales of Capital Gain Assets and Real Property 1

Introduction 1
- Preface Regarding Future Tax Rate Uncertainty 1

Capital Gain and Dividend Tax Rates in a Nutshell 2
- Favorable Capital Gains Rates Through 2012 2
- Qualified Dividends Taxed at Lowest Capital Gains Rates Through 2012 4
- Many Individuals Occupy 10 Percent and 15 Percent Brackets and Pay 0 Percent on Investment Profits Through 2012 6

Tax-Smart Investing Strategies 7
- Tax-Smart Strategies for Capital Gain Assets 7
- Tax-Smart Strategies for Fixed-Income Investments 10
- Borrowing to Buy Dividend-Paying Stocks Is Usually Inadvisable 10
- Variable Annuities Are Damaged Goods 11

Installment Sales of Capital and IRC Section 1231 Assets 12
- Installment Sales of Depreciable Real Estate 12

Planning for Year-End Dispositions of Securities 13
- Capital Gain or Loss Netting Rules in a Nutshell (Through 2012) 14
- Planning for Year-End Mutual Fund Transactions 15
- Donate Appreciated Stock, Sell Loss Stock 16
- Other Year-End Considerations 16

More on Tax Planning for Mutual Funds 17
- What Sale? 18
- Calculating Mutual Fund Share Basis 18
- Foreign Taxes on International Funds 21

Netting Rules and Dispositions of IRC Section 1231 Property Through 2012 21

Converting Capital Gains and Qualified Dividends Into Ordinary Income to Maximize Investment Interest Writeoffs 21
- How to Make the Election 22
- Election Is Not a No-Brainer 22

Special Breaks for Sales of QSBC 23
- General 50 Percent Gain Exclusion Rule 24
- Special 75 Percent Gain Exclusion Rule 24
- Extra-Special 100 Percent Gain Exclusion Rule 24
- Gain Exclusion Basics 24
- AMT Preference for Pre-2013 Sales 26
- AMT Preference for Post-2012 Sales 26
- Limitations on QSBC Gain Exclusion 28

Gain Rollover Rule 30
Qualification Rules for QSBC Gain Exclusion and Gain Rollover Privileges 31
Planning for Capital Gain Treatment for Subdivided Lot Sales 32
Restrictions on IRC Section 1237 Relief 32
Definition of Tract of Real Property 34
Definition of Substantial Improvement 34
Election to Disregard Substantial Improvements 35
The Six-Lot Rule 37
Use S Corporation Developer Entity Strategy to Slash Taxes on Appreciated Land 37
Step 1: Establish S Corporation to Be the Developer Entity 38
Step 2: Sell the Land to the S Corporation 39
Step 3: Develop the Property and Sell It Off 39
Make Sure the Developer Entity Is an S Corporation 39
Anticipate IRS Challenges and Take Steps to Avoid Them 40
Escaping Gains Altogether With a Like-Kind Exchange 41
Like-Kind Exchange Basics 41
Realized Versus Recognized and Receipt of Boot 42
Basis and Holding Period for Like-Kind Property Received 43
Deferred Like-Kind Exchanges 45
Tax Rules for Deferred Exchanges 46
Avoiding Constructive Receipt Problems With Escrow Arrangements 47
Four-Party Exchanges With Qualified Intermediaries 48
"Reverse-Starker Exchanges" Are Now Clearly Allowed 50

Chapter 2. Planning for Employer Stock and Stock Options 55
Introduction 55
Employer Stock Options 55
Buying and Selling ISO Shares 55
AMT Rules for ISO Shares 56
Disqualifying Dispositions of ISO Stock 57
Liberalized AMT Credit Rules for 2008–12 Will Help Those Who Exercised Lucrative ISOs in Prior Years 58
Nonqualified Stock Options 61
Hold That Option, Version 1 62
Hold That Option, Version 2 62
Federal Payroll Tax Implications of Employer Options 63
Nonqualified Options 63
Incentive Stock Options 64
Year-End Sale of ISO Shares Can Avoid AMT Hit 64
But Watch Out for This! 65

Employer Stock From Qualified Retirement Plan Distributions 65
Withdraw Shares and Hold in Taxable Account 66
Rollover Into IRA..67

Chapter 3. All About Roth Individual Retirement Accounts 69
Introduction 69
Roth IRA Basics..69
Roth IRAs Have Two Big Tax Advantages..69
Considerations and Rules for Annual Roth Contributions 70
Help Clients Take Advantage of Wide-Open Roth IRA Conversion Opportunity...73
Whole New Ballgame for Conversions 73
Roth Conversion Basics..75
Roth Conversion Variables 78
Planning for Conversions..80
Bottom Line on Roth Conversions..81
Roth Conversion Case Studies 81
Reversing Ill-Fated Roth IRA Conversions..83
Reversal Basics 83
What If Roth IRA Has Other Contributions? 84
Reporting Reversals 84
Reconverting After Reversals...85
Projecting Retirement Savings Results From Using Tax-Deferred Retirement Accounts, Taxable Accounts, and Roth IRAs 85
Higher Future Taxes Are Possible..86
Cash Is King 86
Roth IRAs Provide "Insurance" Against Bad Outcomes 86
Circumventing the Income Restriction on Annual Roth Contributions 87
Run Scenarios to Compare Retirement Savings Results 88
What Can We Conclude Here?...91
Self-Employed Clients Should Not Overlook Chance to Make Annual Roth IRA Contributions 92
Client's Income Is Too High for Annual Roth Contributions (That May Be Wrong)...93
Plan B May Allow High-Income Clients to Circumvent Restriction on Annual Roth Contributions 95
Roth Contributions Are Less Attractive Than Deductible Retirement Plan Contributions (That May Be Wrong Too) 96
How to Handle Roth IRA Withdrawals 96
The Simplest Case: Qualified Withdrawals...96
More Complicated Cases: Nonqualified Withdrawals.........................97

Special First-Time Home Purchase Provision for Withdrawals Taken Before 59½ 101
Using Roth Conversions for Estate Planning 102
Conclusion 103

Chapter 4. Maximizing Tax Benefits for Personal Residence Transactions .. 105
Introduction 105
Qualification Rules for Gain Exclusion Privilege 105
Ownership and Use Tests 106
What Is a Principal Residence? 106
Gain Exclusion Rules for Married Couples 108
Special Exception for Unmarried Surviving Spouses May Permit Larger $500,000 Gain Exclusion 109
Anti-Recycling Rule 109
Prorated (Reduced) Gain Exclusion Loophole for "Premature" Sales 110
Claiming Exclusion for Home Used Partly for Business or Rental 115
Premature Sale of Property Used for Business or Rental 116
Excluding Gains From Sale of Land Next to Residence 118
Excluding Gains in Marriage and Divorce Situations 119
Sale After Marriage 119
Sale Before Divorce 119
Sale in Year of Divorce or Later 120
When "Nonresident Ex" Continues to Own Home Long After Divorce 121
"Electing Out" of Gain Exclusion Privilege 122
Understanding the Tax Implications of Personal Residence Short Sales and Foreclosures 123
Short Sales Involving Recourse Debt 123
Short Sales Involving Nonrecourse Debt 124
Tax Rules for Cancellation of Debt Income 124
Foreclosures 126
Federal Income Tax Impact of Foreclosure on Borrower 127
Reporting and Treatment of COD Income Arising From Foreclosures ... 129
Exclusion for Principal Residence Mortgage Debt Discharges Will Save the Day for Many Clients 130
Tax Angles When Client Converts Personal Residence Into Rental Property 130
Basis for Loss and Depreciation Purposes Depends on Market Value ... 130
Tax Basis for Gain Purposes Is Different 131
Different Basis Numbers Can Create Weird Results When Property Is Sold 131
Keep Records to Establish FMV on Conversion Date 133

Schedule E Deductions Are Allowed When Converted Residence Is Held Out for Rent Even When There Is No Rental Income ... 133
Reverse Mortgages Can Be a Tax-Smart Deal for Seniors With Greatly Appreciated Residences ... 134
Basis Step-Up Rule to the Rescue ... 135
Reverse Mortgage Basics ... 136
Fees Are High ... 137
Deducting Reverse Mortgage Interest ... 137
Other Reverse Mortgage Considerations ... 138
Beware of Homebuyer Tax Credit Repayment Rules ... 138
Homebuyer Credit Basics ... 139
Repayment Rules for Version 1 (for 2008 Purchases) ... 140
Repayment Rule for Versions 2 and 3 (for 2009 and 2010 Purchases) ... 142

Chapter 5. Tax Planning Opportunities With Vacation Homes, Timeshares, and Co-Ownership Arrangements ... 145
Introduction ... 145
"Regular" Vacation Homes (As Opposed to Timeshares and Co-Ownership Deals) ... 145
Category 1: Rented More Than 14 Days—and Personal Use Exceeds Greater of 14 Days or 10 Percent of Rental Days ... 145
Category 2: Rented More Than 14 Days—and Personal Use Does Not Exceed Greater of 14 Days or 10 Percent of Rental Days ... 147
Category 3: Rented Less Than 15 Days—and Personal Use Exceeds 14 Days ... 148
More on Tax Planning for Category 2 Vacation Homes ... 148
Tax Rules for Timeshares and Vacation Home Co-Ownership Arrangements ... 149
No Rental Days ... 149
Some Rental Days ... 150
Tax-Free Rent Rule ... 151
Paying the Gain Exclusion Game With Multiple Residences ... 152
Unfavorable Rule for Properties Converted Into Principal Residences After 2008 ... 152

Chapter 6. Tax Planning for Marital Splits ... 155
Introduction ... 155
Separate Versus Joint Returns for Pre-Divorce Years ... 156
Marriage Penalty Relief ... 156
Filing Separately to Avoid Liability for Ex-Spouse's Tax "Mistakes" ... 157
Filing Separately as Head of Household ... 162

Other Ways to Avoid Tax Liabilities Caused by Spouses 164
Timing of the Divorce—This Year or Next? 167
Allocations of Taxable Income, Deductions, and Tax Payments.........168
HOH Status in Year of Divorce 169
Divorcing Before Year-End to Avoid Marriage Penalty 170
Postponing Divorce to Collect "Marriage Dividend".......................171
Avoiding Pre-Divorce Tax Fiascos With IRA and Qualified
Retirement Plan Assets 172
Planning to Achieve Tax-Effective Splits of IRA and QRP Assets 173
Splitting Up IRA Assets 173
Splitting Up QRP Account Assets..174
Planning to Achieve Equitable After-Tax Property Divisions..............179
Taking Advantage of the Tax-Free Transfer Rule 180
Transfers of Ordinary-Income Assets 181
Planning for Children's Dependent Exemption Deductions 181
Planning to Qualify Payments as Deductible Alimony.........................182
Requirements for Payments to Constitute Alimony.........................182
Alimony Received Is Earned Income for IRA Contribution Purposes ... 186
Avoiding Characterization of Payments as Child Support 187
Avoiding Alimony Recapture...189

Chapter 7. Tips for Self-Employment Clients...197
Introduction 197
Choice of Business Entity 197
Sole Proprietorships...198
Single-Member LLCs 198
S Corporations 199
Regular Corporations (C Corporations) 201
Qualified Small Business Corporations 205
Active Business Requirement...206
Multi-Member LLCs...207
Limited Liability Partnerships 209
Liability of LLP Partners 210
General Partnerships 212
Limited Partnerships 219
"Heavy" Sport Utilities, Pickups, and Vans Can Still Be Tax-Saving
Machines...222
Skimpy Deductions for Cars, Light Trucks, and Light Vans 223
Bigger Deductions for Heavy Vehicles Used More Than 50 Percent
for Business 223
First-Year Bonus Depreciation Allowed for 2010–12 224
Reduced IRC Section 179 Deduction for Heavy SUVs 226

Despite $25,000 Limitation, Depreciation Rules for Heavy SUVs Are Still Very Favorable....226
IRS Confirms That Heavy SUVs Escape Luxury Auto Depreciation Limits Whether Built on Truck or Car Chassis.....227
Do Not Forget IRC Section 179 Taxable Income Limitation..........228
Do Not Forget IRC Section 179 Deduction Phase-Out Rule....229
Mind Stricter Rules for Corporate-Owned Vehicles....229
Other Caveats....230
No Income Limitation or Phase-Out Rule for First-Year Bonus Depreciation....230
Planning to Reduce Social Security and Medicare Taxes....230
Employing Owner's Children in the Business....231
What About SE Tax for LLC Members?....232
Beating the System by Incorporating....233
Better Long-Term Outlook for S Corporation Modest-Salary Strategy....235
Possible Negative Impact on Owner Retirement Contributions......236
Games You Can Plan With Health Benefits....236
A Potential Solution for Sole Proprietors and Single-Member LLCs..237
Partnerships and Multi-Member LLCs....239
S Corporations....239
What to Do When Spouses Are Active in the SE Activity....240
Advantages of Hiring the Business Owner's Spouse....240
More on the Federal Tax Status of Unincorporated Husband–Wife Businesses....240
SE Tax Planning Opportunities in Community Property States.......242
Update on Simplified Compliance Rules for Unincorporated Husband-Wife Businesses in Noncommunity Property States......246
How to Elect Out of Partnership Status....247
Definition of Qualified Joint Venture....247
IRS Admits Husband–Wife Rental Real Estate Business Can Be Qualified Joint Venture....248
Unofficial IRS Guidance States Husband–Wife LLC Cannot Be Qualified Joint Venture....248

Chapter 8. Tax-Wise College Financing for Middle-Class Clients 251
Introduction....251
Education Tax Credits....251
American Opportunity Credit....251
Lifetime Learning Credit....255
Rules Applying to Both Credits....256
Beating the System....257

Deduction for Higher Education Tuition and Fees 257
Eligibility Rules 258
Maximum Deduction and Income Cut-Off Rule 258
Deduction for Student Loan Interest 259
Coverdell Education Savings Accounts 260
Tax-Free Employer Reimbursements for Higher Education Costs 261
Penalty-Free Individual Retirement Account Withdrawals 261
Tax-Free Interest From U.S. Savings Bonds 262
Qualifying Savings Bonds 262
Qualifying Expenses 263
Computing the Amount of Excluded Interest 263
Phase-Out Rules for Higher-Income Taxpayers 264
Electing the Accrual Method for U.S. Savings Bonds 265
How to Make the Election 266

Chapter 9. Tax-Smart College Financing Maneuvers for High-Income Clients 267
Introduction 267
Splitting Investment Income With the Kids 267
The Kiddie Tax Rules 268
Calculating the Kiddie Tax 273
Saving for College Using Parent's Taxable Account 273
Saving for College Using Child's Roth IRA 274
Financing College With Deductible Payments From a Parent's Business 274
How a Closely Held Business Can Deduct College Expenses Paid for the Owner's Adult Child 275
Meeting the Qualification Rules 275
Dodging the 5 Percent Ownership Bullet 276
State-Sponsored Qualified Tuition Programs (Section 529 Plans) 277
How College Savings Plans Work 277
The Tax Benefits 278
Investment Restrictions and Withdrawal Penalties 279
Which State Plan Is Best? 280
Deducting Section 529 Plan Losses 281

1

Maximizing Tax Benefits for Sales of Capital Gain Assets and Real Property

Introduction

This chapter covers what tax advisers need to know, from both planning and compliance perspectives, to help clients maximize tax savings under the evolving federal income tax rate structure for capital gains and losses and Internal Revenue Code (IRC) Section 1231 gains and losses. It will also cover some tax breaks that apply specifically to real estate transactions.

Preface Regarding Future Tax Rate Uncertainty

Through 2012, the so-called Bush tax cuts are locked in. However, unless the U.S. Congress takes action and the president approves, individual federal income rates will increase in 2013. In the context of high-income individuals and business owners, the following is scheduled to happen:

- For 2013 and beyond, the top 2 rates on ordinary income will increase to 36 percent and 39.6 percent (up from 33 percent and 35 percent).
- For 2013 and beyond, high-income individuals may also be hit with an additional 0.9 percent Medicare tax on part of their wages and self-employment income. However, the additional 0.9 percent tax was part of the controversial healthcare legislation, so it might be repealed.
- For 2013 and beyond, the maximum rate on most long-term capital gains will increase to 20 percent (up from 15 percent). However, an 18 percent maximum rate will apply to most long-term gains from selling assets that are (1) acquired after December 31, 2000, and (2) held more than 5 years.
- For 2013 and beyond, dividends will be taxed at ordinary income rates, which could be as high as 39.6 percent.
- For 2013 and beyond, high-income individuals may be hit with a separate 3.8 percent Medicare tax on all or part of their *net investment income*, which is defined to include long-term gains and dividends. However, the additional 3.8 percent tax was part of the controversial healthcare legislation, so it might be repealed.

So far, there has not been much noise about raising tax rates on corporations that earn their money in the United States. You can take that as an encouraging sign or as the ominous calm before the storm.

Due to budget deficits, many state income tax rates may continue to increase across the board.

Capital Gain and Dividend Tax Rates in a Nutshell

Favorable Capital Gains Rates Through 2012

Thanks to the extension of the so-called Bush tax cuts, most long-term capital gains recognized by individuals through the end of 2012 are taxed at significantly lower federal income tax rates. Clients will notice these low rates in the following areas:

- Most long-term capital gains are taxed at a maximum rate of only 15 percent.
- Most long-term capital gains that would otherwise fall within the 10 percent and 15 percent ordinary income rate brackets are taxed at 0 percent—an unbeatable rate.
- Many more clients than you might think will pay a marginal ordinary income rate of 10 percent or 15 percent and, thus, be eligible for the 0 percent rate.
- Gains from the sale of qualified small business corporation (QSBC) stock held for more than 6 months can be rolled over tax-free if the seller reinvests the proceeds in other newly issued QSBC stock.
- Capital gains from principal residence sales can be entirely excluded from federal income taxation to the extent of up to $500,000 for joint filers and up to $250,000 for unmarried individuals (assuming the IRC Section 121 qualification rules are met).

Some Gains Do Not Qualify for Lowest Rates

Unfortunately, the 15 percent/0 percent rate does not apply to all types of capital gains. Clients will see those gains taxed as follows:

- The reduced rates have no impact on investments held inside a tax-deferred retirement account (traditional individual retirement account [IRA], Keogh, simplified employee pension [SEP] plan, solo 401[k], and so on). So, a client will pay taxes at his or her regular rate (which can be as high as 35 percent through 2012) when gains accumulated in these accounts are withdrawn as cash distributions. (Gains accumulated in a Roth IRA are still federal-income-tax-free as long as the requirements for tax-free withdrawals are met.)
- Clients will still pay taxes at their higher regular rates on net short-term capital gains from investments held for 1 year or less. Therefore, if a client holds appreciated

stock in a taxable account for exactly 1 year, he or she could lose up to 35 percent of his or her profit (through 2012) to the IRS. If the client instead holds on for just 1 more day, his or her tax rate drops to no more than 15 percent (through 2012). Selling just one day too soon could mean losing a much bigger chunk of one's profit to the tax collector.

Key Point: For tax purposes, a client's holding period begins the day after he or she acquires securities and includes the day he or she sells. For example, if your client buys shares on November 1 of this year, his or her holding period begins on November 2. Therefore, November 2 of next year is the earliest possible date he or she can sell and still be eligible for the reduced rates on long-term capital gains.[1]

- IRC Section 1231 gains attributable to depreciation deductions claimed against real estate properties are called unrecaptured IRC Section 1250 gains. These gains, which would otherwise generally be eligible for the 15 percent maximum rate (through 2012), are taxed at a maximum rate of 25 percent.[2] The good news is that any IRC Section 1231 gain over and above the amount of unrecaptured IRC Section 1250 gain from a real property sale is generally eligible for the 15 percent maximum rate on long-term capital gains (through 2012). The same treatment applies to the deferred IRC Section 1231 gain component of installment note payments from an installment sale transaction.

Key Point: Distributions from real estate investment trusts (REITs) and REIT mutual funds may include some unrecaptured IRC Section 1250 gains from real property sales. These gains, which are taxed at a maximum rate of 25 percent, should be separately reported to the investor and entered on the appropriate line of the client's Schedule D.

- The 28 percent maximum rate on long-term capital gains from sales of collectibles and QSBC stock remains in force.[3]

Alternative Minimum Tax Treatment of Capital Gains

The preferential capital gains rates apply equally for both regular tax and alternative minimum tax (AMT) purposes. However, significant capital gains can still push individuals into the AMT mode because the additional taxable income from the gains can cause individuals to lose some or all of their AMT exemption due to the exemption phase-out rule. In addition, gains can trigger higher state income taxes. Because the deduction for state income taxes is completely disallowed under the AMT rules, this further increases the odds of owing the AMT.

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1 See Rev. Ruls. 66-7 and 66-97.

2 Internal Revenue Code (IRC) sec. 1(h)(6).

3 IRC sec. 1(h)(5) and (7).

Qualified Dividends Taxed at Lowest Capital Gains Rates Through 2012

Thanks to the extension of the so-called Bush tax cuts, qualified dividends are taxed at the same federal income tax rates as long-term capital gains through 2012 as follows:

- Qualified dividends are taxed at a maximum rate of 15 percent.
- Qualified dividends that would otherwise fall within the 10 percent and 15 percent ordinary income rate brackets are taxed at the unbeatable rate of 0 percent.
- Many more clients than you might think will pay a marginal ordinary income rate of 10 percent or 15 percent and, thus, be eligible for the 0 percent rate through 2012. This will be discussed subsequently.

Not All Dividends Are Eligible for Lowest Rates

The 15 percent/0 percent rate on dividends (through 2012) applies only to qualified dividends paid on shares of corporate stock.[4] However, payments that are commonly called "dividends" are not necessarily qualified dividends under the tax law, for example, in the following areas:

- Dividends paid on credit union accounts are really interest payments. As such, they are considered ordinary income and are therefore taxed at regular rates—which can be as high as 35 percent (through 2012).
- The same is true for dividends paid on some preferred stock issues that are actually publicly traded "wrappers" around underlying bundles of corporate bonds. Clients should not buy preferred shares for their taxable accounts without knowing exactly what they are buying.
- Mutual fund dividend distributions that are paid out of a fund's short-term capital gains, interest income, and other types of ordinary income are taxed at regular rates. That means equity mutual funds that engage in rapid-fire trading of low-dividend growth stocks will generate payouts that are taxed at up to 35 percent (through 2012) rather than at the optimal 15 percent/0 percent rate (through 2012) your client might be hoping for.
- Bond fund dividends are taxed at regular rates, except to the extent the fund is able to reap long-term capital gains from selling appreciated assets.
- On a positive note, mutual fund dividends paid out of (1) qualified dividends from a fund's corporate stock holdings and (2) long-term capital gains from selling appreciated securities are eligible for the 15 percent/0 percent rate (through 2012).
- Most REIT dividends are not eligible for the 15 percent/0 percent rate, because the main sources of cash for REIT payouts are usually not qualified dividends from corporate stock held by the REIT or long-term capital gains from asset sales. Instead, most payouts are derived from positive cash flow generated by the REIT's real estate properties. Most REIT dividends, therefore, will be ordinary income taxed at regular

[4] IRC sec. 1(h)(11).

rates. As a result, clients should not buy REIT shares for their taxable accounts with the expectation of benefiting from the 15 percent/0 percent rate.

- Dividends paid on stock in qualified foreign corporations are theoretically eligible for the 15 percent/0 percent rate (through 2012). However, these dividends are often subject to foreign tax withholding. Under the U.S. foreign tax credit rules, individual investors may not necessarily receive credit for the full amount of withheld foreign taxes, meaning investors can wind up paying the advertised 15 percent/0 percent rate to the U.S. Treasury, plus some incremental percentage to some foreign country. Unfortunately for clients, the combined U.S. and foreign tax rates may exceed the advertised 15 percent/0 percent rate.[5]
- Finally, the 15 percent/0 percent rate does not apply to dividends earned inside tax-deferred retirement accounts (traditional IRA, Keogh, SEP, solo 401[k], and so on). Clients are taxed at their regular rates when dividends accumulated in these accounts are withdrawn as cash distributions. (Dividends accumulated in a Roth IRA are federal-income-tax-free as long as the client meets the requirements for tax-free withdrawals.)

Warning: To be eligible for the 15 percent/0 percent rate (through 2012) on qualified dividends earned in a taxable account, the stock on which the dividends are paid must be held for more than 60 days during the 120-day period that begins 60 days before the ex-dividend date (the day following the last day on which shares trade with the right to receive the upcoming dividend payment). When shares are owned only for a short time around the ex-dividend date, the dividend payout will count as ordinary income taxed at regular rates.[6]

Favorable Ordinary Income Rates Through 2012

Thanks to the so-called Bush tax cuts, your individual client's ordinary income items from self-employment, salary, interest, alimony, and the like are subject to favorable federal income rates, too. Table 1-1 shows the 2012 federal income tax rates and brackets.

Table 1-1: Individual Federal Income Tax Structure for 2012

	Single	Joint	HOH	MFS
10% Tax Bracket	\$0–\$8,700	\$0–\$17,400	\$0–\$12,400	\$0–\$8,700
Beginning of 15% Bracket	8,701	17,401	12,401	8,701
Beginning of 25% Bracket	35,351	70,701	47,351	35,351
Beginning of 28% Bracket	85,651	142,701	122,301	71,351
Beginning of 33% Bracket	178,651	217,451	198,051	108,726
Beginning of 35% Bracket	388,351	388,351	388,351	194,176
Standard Deduction	5,950	11,900	8,700	5,950

(continued)

[5] See IRC sec. 1(h)(11)(C)(iv) and IRC sec. 904.

[6] IRC sec. 1(h)(11)(B)(iii).

Long-term capital gains and qualified dividends in 10 percent and 15 percent rate brackets—0 percent
Long-term capital gains and qualified dividends in higher rate brackets—15 percent
Sunset Rules: After 2012, ordinary income rates will return to 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent unless Congress takes action. After 2012, capital gain taxes will revert to the "old-law" rates and dividends will again be taxed at ordinary income rates unless Congress takes action.

Many Individuals Occupy 10 Percent and 15 Percent Brackets and Pay 0 Percent on Investment Profits Through 2012

As explained earlier in this chapter, long-term capital gains and qualified dividends earned in an individual's taxable account are taxed at 0 percent when they fall within the 10 percent and 15 percent federal rate brackets (through 2012). Many more clients than you might initially think are eligible for these bottom two rate brackets. Remember that a taxpayer's rate bracket is determined by the amount of *taxable income*, which equals gross income reduced by allowable personal and dependency exemptions, and by the standard deduction amount (if the taxpayer does not itemize) or total itemized deductions (if he or she does itemize). Consider the following hypothetical situations:

- A client is a married joint filer with two dependent kids. Assuming he claims the standard deduction, his gross income for 2012 can be as high as $97,800, and he will still be within the 15 percent rate bracket. In other words, if his total income—including long-term capital gains and qualified dividends earned in taxable accounts—equals $97,800 or less, he will owe the IRS nothing on those dividends and gains.
- A client is a single parent with two dependent kids, and she claims the standard deduction and uses head of household filing status. Her 2012 gross income can be as much as $67,450, and she will still be in the 15 percent bracket. So, she too can take advantage of that sweet 0 percent rate on long-term capital gains and qualified dividends earned in her taxable account.
- A client is single with no dependents, and he claims the standard deduction. His 2012 gross income can be as much as $45,100, and he will still be in the 15 percent bracket.
- A client itemizes her deductions. Her gross income can be even higher than the figures listed in previous examples, and she may still be within the 15 percent bracket.

Key Point: Despite some statements to the contrary, a taxpayer certainly does not have to be "poor" (or anything close to "poor") to be eligible for the 0 percent rate. However, individuals should still take full advantage of all opportunities to make deductible contributions to their tax-deferred retirement accounts. Then, they can invest the resulting tax savings, along with any other surplus cash, in taxable accounts and lock in the 0 percent rate.

Tax-Smart Investing Strategies

Tax-Smart Strategies for Capital Gain Assets

Clients should try to satisfy the more-than-one-year holding period rule before selling appreciated investments held in taxable accounts. That way, they will qualify for the 15 percent/0 percent long-term capital gains rate (through 2012). The higher the client's tax rate on ordinary income, the more this advice rings true. Of course, the client should never expose an accrued profit to great downside risk solely to be eligible for a lower tax rate. The client is always better off bagging a short-term profit and paying the resulting higher tax bill than hanging on too long and losing his or her profit altogether.

Clients should hold equity index mutual funds and tax-managed funds in taxable investment accounts. These types of funds are much less likely to generate ordinary income dividends that will be taxed at higher regular rates. Instead, these funds can be expected to generate qualified dividends and long-term capital gains that will be taxed at the 15 percent/0 percent rate (through 2012).

Clients should hold mutual funds that engage in rapid-fire asset churning in tax-advantaged retirement accounts. That way, the ordinary income generated by these funds will not cause any tax harm.

If a client insists on engaging in rapid-fire equity trading, he or she should confine that activity to his or her tax-advantaged retirement accounts where there is no tax disadvantage to lots of short-term trading.

> **Key Point:** If a client's equity investing style involves nothing but rapid-fire trading in stocks and ownership of quick-churning mutual funds, he or she should try to do this inside his or her tax-advantaged retirement accounts, because using this style in a taxable account generates ordinary income taxed at higher regular rates. Inside a tax-advantaged retirement account, however, there is no harm done. If the client therefore devotes most or all of his or her tax-advantaged retirement account balances to such rapid-fire equity trading, he or she might be forced to hold some or all of his or her fixed-income investments in taxable accounts, which is acceptable. Even though the client will pay his or her higher regular rate on the ordinary income produced by those fixed-income assets, he or she should still come out ahead on an overall after-tax basis.

Broad-Based Stock Index Options

The 2012 federal income tax rates on long-term capital gains are very low, ranging from a minimum of 0 percent to a maximum of 15 percent depending on a taxpayer's tax bracket. But the rates on short-term gains are not so low, ranging from 15 percent–35 percent for most investors. That is why, as a general rule, clients should try to satisfy the more-than-one-year holding period requirement for long-term gain treatment before selling winner shares (that is, worth more than a client paid for them) held in taxable brokerage firm accounts. That

way, the IRS won't be able to take more than 15 percent of a client's profits. Unfortunately, today's investment climate is not necessarily conducive to making such long-term commitments. Instead of following the conventional-wisdom buy-and-hold strategy, buy-and-hope might seem more appropriate. But that can result in short-term gains that are heavily taxed.

One popular way to place short-term bets on broad stock market movements is by trading in exchange traded funds (ETFs), such as QQQ (which tracks the NASDAQ 100 index) and SPY (which tracks the Standard & Poor's [S&P's] 500 index). Of course, when clients sell ETFs for short-term gains, they must pay their regular federal tax rate, which can be as high as 35 percent. The same is true for short-term gains from precious metal ETFs, such as GLD or SLV. Even long-term gains from precious metal ETFs can be taxed at up to 28 percent, because the gains are considered collectibles gains.

Thankfully, clients can play the market in a short-term fashion while paying a lower tax rate on your gains by trading in broad-based stock index options.

Favorable Tax Rates on Short-Term Gains From Trading in Broad-Based Stock Index Options

The IRC treats broad-based stock index options, which look and feel a lot like options to buy and sell comparable ETFs, as IRC Section 1256 contracts. Specifically, broad-based stock index options fall into the nonequity option category of IRC Section 1256 contracts.[7]

IRC Section 1256 contract treatment is a good deal for investors because gains and losses from trading in IRC Section 1256 contracts are automatically considered to be 60 percent long-term and 40 percent short-term.[8] A client's holding period for a broad-based stock index option doesn't matter. The tax-saving result is that short-term profits from trading in broad-based stock index options are taxed at a maximum effective federal rate of only 23 percent ([0.60 × 0.15] + [0.40 × 0.35]). If the client is in the top 35 percent bracket for 2012, that's a whopping 34 percent reduction in his or her tax bill. The effective rate is lower if the client is not in the top bracket. For example, for a client in the 25 percent bracket, the effective rate on short-term gains from trading in broad-based stock index options is only 19 percent ([0.60 × 0.15] + [0.40 × 0.25]). That's a 24 percent reduction in your client's bill.

> **Key Point.** With broad-based stock index options, individuals pay a significantly lower tax rate on gains without having to make any long-term commitment. In today's turbulent investing environment, that's a nice advantage.

Favorable Treatment for Losses Too

If a taxpayer suffers a net loss from IRC Section 1256 contracts, including losses from broad-based stock index options, an election can be made to carry back the net loss for three years to offset net gains from IRC Section 1256 contracts recognized in those earlier years,

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7 See IRC sec. 1256(b)(1) and (g)(3) and IRS Publication 550, *Investment Income and Expenses*, under the heading "Section 1256 Contracts Marked to Market."

8 IRC sec. 1256(a)(3).

including gains from broad-based stock index options.[9] In contrast, garden-variety net capital losses can only be carried forward.

Year-End Mark-to Market Rule

As the price to be paid for the aforementioned favorable tax treatment, taxpayers must follow a special mark-to-market rule at year-end for any open positions in broad-based stock index options.[10] That means a client will pretend to sell his or her positions at their year-end market prices and include the resulting gains and losses on his or her tax return for that year. Of course, if the client doesn't have any open positions at year-end, this rule will not affect him or her.

Reporting Broad-Based Stock Index Option Gains and Losses

According to IRS Publication 550, both gains and losses from closed positions in broad-based stock index options and year-end mark-to-market gains and losses from open positions are reported on Part I of Form 6781 (Gains and Losses from Section 1256 Contracts and Straddles). The net short-term and long-term amounts are then transferred to Schedule D.

Finding Broad-Based Stock Index Options

A fair number of options meet the tax-law definition of broad-based stock index options, which means they qualify for the favorable 60/40 treatment and the favorable loss carryback rule. Clients should consider options that track major stock indexes such as the S&P 500 and the Russell 1000 and major industry and commodity sectors such as utilities, tech, oil, and gold. One place to identify options that qualify as broad-based stock index options is www.tradelogsoftware.com/support/user-guide/support-index-options.php.

Although trading in these options is not for the faint-hearted, it's something to think about if a client considers market volatility to be a friend.

Gifts of Appreciated Securities

High-bracket clients should consider gifting away appreciated securities to their low-bracket children and grandchildren (assuming the kiddie tax does not apply). For instance, if your client has an adult child, the client can give the child up to $13,000 worth of appreciated securities without any adverse gift or estate tax consequences for the client, as can the client's spouse. The child can then sell the appreciated securities and pay 0 percent (through 2012) of the resulting long-term capital gains to the U.S. Treasury (assuming the child is in the 10 percent or 15 percent tax bracket). The same 0 percent rate applies (through 2012) to qualified dividends collected from dividend-paying shares the child receives as gifts from his or her parents again assuming he or she is in the 10 percent or 15 percent bracket. For this idea to work, however, client and child must together hold the appreciated securities for more than 1 year.

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[9] See IRC sec. 1212(c).

[10] IRC sec. 1256(a).

Warning: This strategy can backfire if the child is under age 24. Under the kiddie tax rules, some or all of the youngster's capital gains and dividends may be taxed at the parents' higher rate, which would defeat the purpose of this strategy.

Tax-Smart Strategies for Fixed-Income Investments

The federal income tax rate structure penalizes holding ordinary-income-producing investments in taxable account compared to stocks that taxpayers expect to generate qualified dividends and long-term capital gains. Advisers should recommend that clients generally put fixed-income assets that generate ordinary income (such as Treasuries, corporate bonds, and CDs) into their tax-deferred retirement accounts in order to avoid the tax disadvantage.

The federal income tax rate structure also penalizes holding REIT shares in a taxable account compared to garden-variety corporate shares that the client expects to generate qualified dividends and long-term capital gains. REIT shares deliver current income in the form of high-yielding dividend payouts, plus the potential for capital gains, plus the advantage of diversification. These are all nice attributes inside a tax-deferred retirement account. Inside a taxable account, however, REIT shares receive less-favorable treatment than garden-variety corporate shares because their dividend payments are not treated as qualified dividends. Therefore, the tax-deferred retirement account is now generally the best place to keep one's REIT stock investments.

Borrowing to Buy Dividend-Paying Stocks Is Usually Inadvisable

Here is an idea: your client can borrow money to acquire dividend-paying stocks for his or her taxable investment account. Then he or she can deduct the interest expense against an equal amount of ordinary income that would otherwise be taxed at up to 35 percent (through 2012). Meanwhile, the client pays only 15 percent or 0 percent (through 2012) on all the qualified dividends and long-term capital gains thrown off by his savvy stock investments. Great idea, right? Probably not!

First, many individuals will find themselves unable to claim current deductions for some or all of the interest expense from borrowing to buy investments because a loan used to acquire investment assets generates investment interest expense. Unfortunately, investment interest can only be deducted to the extent of the individual's net investment income for the year.[11] Any excess investment interest is carried over to the next tax year and subjected to the very same net investment income limitation all over again.

Net investment income means interest, net short-term capital gains (that is, excess of net short-term capital gains over net long-term capital losses), certain royalty income, and the like reduced by allocable investment expenses other than investment interest expense. Investment income does not include net capital gains (that is, excess of net long-term capital

[11] IRC sec. 163(d).

gains over net short-term capital losses). Under the current rules (through 2012), investment income does not include qualified dividends either.[12]

Despite the preceding general rules, an individual can elect to treat specified amounts of net capital gain and qualified dividends as investment income in order to "free up" a bigger current deduction for investment interest expense. If the election is made, the elected amounts are treated as ordinary income and are taxed at regular rates.[13] So when the election is made, the increased investment interest deduction and the elected amounts of net capital gains and qualified dividends wind up offsetting each other at ordinary income rates. As a result, there is generally no tax advantage to borrowing to buy stocks. (The exact tax results of making or not making the election are explained in detail later in this chapter.) The big exception is when the individual can avoid making the election because he or she has sufficient investment income, generally from interest and short-term capital gains, to currently deduct all his or her investment interest expense.

Even when the investment interest expense limitation can be successfully avoided, there is another tax-law quirk to worry about. It arises when the client borrows to acquire stocks via his or her brokerage firm margin account. The brokerage firm can lend to short sellers shares held in the client's margin account worth up to 140 percent of the margin loan balance. As compensation, the client then receives *payments in lieu of dividends*. These payments compensate the client for the dividends he or she would have otherwise received from the shares that were lent out to short sellers. Unfortunately, these payments in lieu of dividends do not qualify for the 15 percent or 0 percent rates (through 2012). Instead, they are considered to be ordinary income.

> **Key Point:** The tax planning solution is to keep dividend-paying stocks in a separate brokerage firm account that has no margin loans against it.

Purely from a tax perspective, one scenario in which it could make sense to borrow to buy dividend-paying stocks is when a client uses home equity loan proceeds to complete a deal. Assuming the client can deduct all the interest on the home equity loan, this is a tax-favored arrangement. However, borrowing against one's home to invest in the stock market is obviously a risky business.

Variable Annuities Are Damaged Goods

Variable annuities are basically mutual fund investments wrapped up inside a life insurance policy. Earnings are tax-deferred, but they are treated as ordinary income when withdrawn. So the investor pays his or her regular tax rate at that time even if most or all of the variable annuity's earnings were from dividends and capital gains that would otherwise qualify for the 15 percent/0 percent rate (through 2012). This factor, plus the high fees charged by insurance companies on variable annuities, makes these products very problematic. It can take many (too many) years for the tax-deferral advantage to overcome the inherent disadvantages, that is, if the investor ever catches up at all.

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[12] IRC sec. 163(d)(4)(B).

[13] IRC sec. 1(h)(2) and 1(h)(11)(D)(i).

Installment Sales of Capital and IRC Section 1231 Assets

The capital gains tax rate reductions included in the Bush tax cuts generally affect sales transactions closed after May 5, 2003. However, the reduced rates also apply to the capital gain component of installment payments *received after* May 5, 2003, and before 2013—even for sale transactions occurring before the May 5, 2003, effective date. This favorable rule has the several implications.

For the capital gain component of installment payments received through 2012, the maximum rate is generally 15 percent for property held more than 12 months at the time of sale (0 percent for gains that would otherwise fall into the 10 percent or 15 percent tax bracket).[14]

Example 1-1

Richard made a deferred payment sale of a capital asset on June 19, 2000. The sale generated a large taxable gain, and the asset had been owned for 13 months at the time of sale.

Richard collected a down payment at closing and the initial installment payment on December 19, 2000. Subsequent installment payments are due each June 19 and December 19 through 2012.

On Richard's Schedule D, the capital gain component of all payments received through 2012 should be treated as qualifying for the 15 percent/0 percent maximum rate, because the property had been held more than 12 months at the time of sale.

Example 1-2

Use the same facts as in example 1-1, except the capital asset has been held for only 11 months at the time of sale.

In this case, no part of the installment payments will qualify for the preferential long-term capital gains rates, because the more-than-one-year holding period rule was not met at the time of sale.

Therefore, the capital gain component of each payment is treated as a short-term capital gain and taxed at Richard's regular rate.

Installment Sales of Depreciable Real Estate

Legislation enacted in 1997 established a 25 percent maximum rate for certain IRC Section 1231 gains treated as long-term capital gains from sales of IRC Section 1250 property. IRC Section 1250 property is otherwise known as depreciable real estate.

The 25 percent rate can potentially apply to long-term capital gains up to the amount of depreciation not already treated as ordinary income under the familiar *old* IRC Section 1250 recapture rules that have been around for many years. Capital gains taxed at this 25 percent rate are therefore termed *unrecaptured IRC Section 1250 gains*.

Despite some confusion, the unrecaptured IRC Section 1250 gain rule has no effect on the old IRC Section 1250 ordinary income recapture rule. The only effect of the newer rule

[14] IRC sec. 1(h).

is to impose a 25 percent maximum rate on depreciable real estate gains that would otherwise qualify for the 15 percent maximum rate (through 2012). For the 25 percent rate to apply, the property must have been held more than 12 months at the time of sale.

Without question, the capital gain component of installment payments from depreciable real estate sales *after* May 5, 2003, could include an unrecaptured IRC Section 1250 gain component. The unrecaptured IRC Section 1250 gain concept also applies to the capital gain component of installment payments received after May 5, 2003, from depreciable real estate sales *before* May 6, 2003, per Treasury Regulation 1.453-12. For installment payments received after May 5, 2003, the capital gain component over and above the unrecaptured IRC Section 1250 gain amount (if any) qualifies for the 15 percent maximum rate (through 2012).

Unfortunately, when there is unrecaptured IRC Section 1250 gain, Treasury Regulation 1.453-12 requires the taxpayer to recognize 100 percent of that amount (taxed at maximum rate of 25 percent) before recognizing any gain eligible for the 15 percent/0 percent maximum rate (through 2012). This result flows from the calculations made on Form 6252 (Installment Sale Income), Form 4797 (Sales of Business Property), and Page 2 of Schedule D.

Planning for Year-End Dispositions of Securities

When year-end approaches, investors are always interested in the traditional tax planning move of selling *loser* securities to offset earlier capital gains or selling *winners* that can be sheltered by earlier capital losses. However, the various rates that can now apply to capital gains make maximizing tax savings from year-end selling more complicated than ever. The good news is the impact of the netting rules on year-end tax selling actually makes intuitive sense (believe it or not). The netting rules are explained subsequently.

All other things being equal at the time when year-end tax selling is undertaken, taxpayers with realized net capital gains in all the rate groups will achieve the greatest savings by selling short-term losers to offset short-term gains first. Losers in the 28 percent group are next best, and losers from the 15 percent group bring up the rear. Once all the capital gains have been offset, another $3,000 of capital losses from any and all rate groups ($1,500 for married filing separate status) can be taken and deducted against ordinary income.

Taxpayers with realized net capital losses in all the rate groups (except the 25 percent group, in which there are none) do best by first selling short-term winners that will be offset by the short-term loss. This avoids gains that could otherwise be taxed at rates as high as 35 percent. Winners in the 28 percent group can be sold next and sheltered with losers from that category and from any remaining net short-term loss. Depreciable real estate gains in the 25 percent group can be offset by IRC Section 1231 losses on page 1 of Form 4797. Finally, winners in the 15 percent group can be sold.

If, after selling some winners, there is still a net capital loss (from any and all rate groups) left over, it is deductible to the extent of $3,000 ($1,500 for married filing separate). When the taxpayer has already sold enough winners to offset his or her capital losses and still wants

to unload even more winners, the obvious guideline, all other things being equal, is to first sell from the 15 percent rate group, then from the 25 percent group, then from the 28 percent group. Short-term winners should be sold last.

Capital Gain or Loss Netting Rules in a Nutshell (Through 2012)

For purposes of netting capital gains and losses, gains and losses recognized through 2012 can potentially fall into four different *rate groups*:

- *Ordinary (short-term) rate group.* The ordinary rate group is for assets held 1 year or less, the gains from which would be taxed at ordinary rates (in other words, short-term capital gains).
- *15 percent rate group.* The 15 percent rate group is for assets held over 1 year, the gains from which would be subject to the 15 percent maximum rate (or the 0 percent rate for gains that would otherwise be included in the 10 percent or 15 percent brackets).
- *25 percent rate group.* The 25 percent rate group is for assets held over 1 year, the gains from which would be subject to the 25 percent maximum rate on *unrecaptured Section 1250 gains*. Some capital gains distributions from REITs can include unrecaptured IRC Section 1250 gains in the 25 percent rate group.
- *28 percent rate group.* The 28 percent rate group is for assets held over 1 year, the gains from would be subject to the 28 percent maximum rate. Assets in this category are collectibles and QSBC stock eligible for the IRC Section 1202 50 percent, 75 percent, or 100 percent gain exclusion.

> **Key Point:** Netting rules are required to allow taxpayers to offset a net gain in one rate group with net losses from other rate groups. These netting rules are implemented automatically if Schedule D and Form 4797 are completed properly.

Utilization of Ordinary (Short-Term) Rate Group Losses

Short-term capital losses are first used to offset any short-term capital gains. Any net short-term loss is then used to offset any net gain in the 28 percent rate group, then any gains in the 25 percent rate group, and finally any net gain in the 15 percent rate group. If there is a net short-term capital gain after subtracting short-term capital losses, the net short-term gain is taxed at ordinary rates.

Utilization of 28 percent Rate Group Losses

Losses from the 28 percent rate group are first used to offset any gains in the 28 percent rate group, then any gains in the 25 percent rate group, then any net gain in the 15 percent rate group, and finally any net short-term gain. If there is a net 28 percent gain after subtracting 28 percent losses, the net gain is taxed at a maximum rate of 28 percent.

Utilization of 25 percent Rate Group Losses

There is no such thing as a 25 percent rate group loss, because the 25 percent rate group includes only *unrecaptured IRC Section 1250 gains* from sales of depreciable real estate. However, if the taxpayer has a net IRC Section 1231 loss, it will offset 25 percent gains on page 1 of Form 4797. As explained elsewhere in this book, net losses from other rate groups can also offset gains from the 25 percent rate group. Any net 25 percent gain (after reductions by IRC Section 1231 losses and net losses from other rate groups) is taxed at a maximum rate of 25 percent.

Utilization of 15 percent Rate Group Losses

Losses from the 15 percent rate group are first used to offset any gains in the 15 percent rate group, then any net gain in the 28 percent rate group, then any gains in the 25 percent rate group, and finally any net short-term gain. Any net 15 percent gain remaining after this netting process is taxed at a maximum rate of 15 percent (or 0 percent if applicable).

Carryover of Unused Net Long-Term Capital Losses

Any unused net long-term capital losses from the 15 percent or 28 percent rate groups are carried forward to the following tax year and are treated as losses in the 28 percent rate group (see Schedule D).

Carryover of Unused Net Short-Term Capital Losses

Any unused net short-term capital losses are carried forward to the following tax year and retain their short-term character.

Planning for Year-End Mutual Fund Transactions

When clients are considering selling appreciated mutual fund shares near year-end, they should pull the trigger *before* that year's dividend distribution. That way, the entire gain—including the amount attributable to the upcoming dividend—will be taxed at no more than 15 percent through 2012 (assuming the shares have been held more than 12 months). In contrast, if the client puts off selling until after the "ex-dividend" date, he or she is locked into receiving the payout. Some of that will probably be taxed at ordinary rates. In other words, inaction can convert a 15 percent gain into an ordinary income dividend taxed at up to 35 percent for through 2012.

For the same reason, it can pay to put off buying into a fund until after the ex-dividend date. If the investor acquires shares just before the magic date, he or she will get the dividend and the tax bill that comes along with it. In effect, he or she will be paying taxes on gains earned before he or she bought in, which is not a good idea.

To get the best tax results, the client should be advised to contact the fund and ask for the expected year-end payout amount and the ex-dividend date. Then transactions can be timed accordingly.

Donate Appreciated Stock, Sell Loss Stock

If the client plans to make charitable contributions before year-end and owns appreciated stock, he or she should consider donating the stock instead of cash. The client gets a deduction equal to the full value of the shares and avoids having to pay tax on the gain as long as he or she owned the shares for more than a year.

In the case of loss stock, the opposite strategy should be employed. Advise the client to sell his or her shares and contribute the cash to charity. The client will get double tax benefits. The capital loss from the sale offsets his or her capital gains from other transactions, plus he or she gets a charitable deduction equal to the value of the stock.

For any contributions of $250 or more, the client should insist on a written receipt or acknowledgment. It is best to get the receipt *immediately*, because if he or she does not have it by tax return filing time, the IRS can completely disallow the deduction.

Other Year-End Considerations

Keep in mind that investments currently in the short-term rate group can wind up being winners in the 15 percent group (through 2012), if the investor hangs on long enough to meet the more-than-12-months rule assuming, of course, that gains will eventually be realized.

Also remember that once it is decided that certain shares will be sold, it generally makes sense to first sell those with the highest basis. This is called the *specific ID method* of calculating the tax basis of shares, and it maximizes tax losses and minimizes gains. When shares in the same stock or mutual fund have been purchased in blocks at various prices, the broker must be instructed regarding which specific block the shares are to be sold from. (Mutual funds generally require written notice by letter or fax.) According to the IRS, the shares must be identified by reference to the purchase date and per share price, and the broker must then confirm the instructions in writing within a reasonable period of time. Otherwise, basis of shares being sold must be determined using the first-in-first-out (FIFO) method.

Written confirmations are a nicety that may be unavailable in today's world of discount brokerages and online trading. According to a 1994 U.S. Tax Court decision,[15] it is sufficient for the taxpayer to give oral instructions regarding the shares he or she wants to sell by reference to their acquisition date and price. The taxpayer need not receive a written confirmation from the broker. Note that the taxpayer must still maintain some sort of proof regarding the oral instructions given to the broker. Scribbling a note on the hard copy transaction statement or keeping a log with one's tax records should do the trick.

Obviously, it is way too late to select the specific ID method at tax return preparation time, so clients must be instructed on the requirements before sale transactions take place. For shares other than mutual funds, the FIFO method is the only alternative when the specific ID method is not used.

When the specific ID method is not used for mutual fund shares, the alternatives are the average basis method (generally more favorable in a rising market) and the FIFO method.

[15] *Concord Instruments Corp.*, TC Memo 1994-248.

(The average basis method is not available for *regular* stock shares.) These days, almost all mutual funds provide average basis information automatically, so there is no need for advisers (or clients) to make the calculations.

Last but not least, remember that investors can inadvertently negate the tax benefits from selling losers by running afoul of the IRC Section 1091 wash sale rule. This trap for the unwary is not new, but it still disallows losses when the same security is purchased within 30 days before or after a loss sale transaction. (The disallowed loss is added to the basis of the purchased securities, which will help some time in the future.)

More on Tax Planning for Mutual Funds

The good thing about equity mutual funds is they are managed by professionals. These folks should be (better be) well-qualified to judge which stocks are most attractive, given a client's investment objectives. The bad thing about funds (besides the fees) is that the client has virtually no control over taxes.

The fund—not the client—decides which of its investments will be sold and when. If its transactions during the year result in an overall gain, the client will receive a taxable distribution (also known as a dividend) whether he or she likes it or not. Funds are required to pass out almost all of their gains every year or pay corporate income tax. (The special federal income tax rules for mutual funds are found in IRC Section 852.) When the client gets a distribution, he or she will owe the resulting tax bill even though his or her fund shares may have actually declined since he or she bought in.

This *unwanted distribution* issue is less of a problem with index funds and so-called tax-efficient (also known as tax-managed) funds. Index funds essentially follow a buy and hold strategy, which tends to minimize taxable distributions. Tax-efficient funds also lean toward a buy-and-hold philosophy, and when they do sell securities for gains, they attempt to offset them by selling some losers in the same year. This approach also minimizes taxable distributions.

In contrast, funds that actively *churn* their stock portfolios in attempting (sometimes futilely) to maximize returns will usually generate hefty annual distributions in a rising market. The size of these payouts can be annoying enough, but it is even worse when a large percentage comes from short-term gains because they are taxed at the investor's ordinary rate (as high as 35 percent through 2012).

On the other hand, funds that buy and hold stocks will pass out distributions mainly taxed at no more than 15 percent (through 2012).

If your client will be investing via taxable accounts, he or she should really look at what kind of *after-tax* returns various funds have been earning and use these figures in picking between competing funds. If the client is using a tax-deferred retirement account (IRA, 401[k], and so on) or a tax-free Roth IRA to hold his or her mutual fund investments, he or she can focus strictly on total return and ignore the tax woes from distributions.

What Sale?

Like *regular* stock shares, mutual fund shares can be sold outright. A client can sell and get cash on the barrelhead. When this happens, he or she is (hopefully) well aware he or she must figure his capital gain or loss for tax purposes. Mutual fund companies allow investors to make other transactions that are also treated as taxable sales—or not, depending on the circumstances. The added convenience is fine and dandy, as long as the client understands the tax ramifications. The following are examples of the three biggest problem areas:

- A client can write checks against his account with the cash coming from liquidating part of his investment in fund shares. When he takes advantage of this arrangement, he has made a sale. He must now calculate the taxable gain or loss on the deal.
- A client switches her investment from one fund in a mutual fund *family* to another. This is a taxable sale.
- A client decides to sell 200 shares in a fund for a tax loss. Because he participates in the fund's dividend reinvestment program, he automatically buys 50 more shares in that same fund within 30 days before *or* after the loss sale. For tax purposes, he made a *wash sale* of 50 shares. As a result, the tax loss on those shares is disallowed. However, he does get to add the disallowed loss to his tax basis in the 50 shares acquired via dividend reinvestment.

Calculating Mutual Fund Share Basis

Once it is determined that there has indeed been a taxable sale, the next step is to compute the capital gain or loss. For this, you need to know the tax basis of the shares that were sold. When blocks of fund shares are purchased at different times and prices, it creates several "layers," each with a different per-share price. When some of the shares are sold, you need a method to determine which layer those shares came from, so you can figure their tax basis and calculate the capital gain or loss. Three methods are available:

- FIFO
- Average basis
- Specific identification

FIFO Method

FIFO assumes the shares that are sold come from the layers purchased first. In rising markets, FIFO gives the *worst* tax answer because it maximizes gains. However, FIFO must be used unless the client takes action to use the average basis or specific ID methods explained later in this chapter.

Example 1-3

A client bought his first 200 shares in the SoSo Fund for $10 each (the first layer). Later, he bought another 200 shares at $15 (the second layer). He then sold 160 shares at $17.50.

Under FIFO, the client is considered to have sold his shares out of the first layer, which cost only $10 each. His capital gain is $1,200 ($2,800 proceeds, less $1,600 basis).

Average Basis

Using this method, the investor figures his or her average basis in fund shares any time he or she makes a sale.

Example 1-4

Use the facts in example 1-3, except the client now uses the average basis method to calculate his gain or loss. The average basis per share is $12.50 ($5,000 total cost divided by 400 shares).

Now the capital gain is only $800—$2,800 proceeds less basis of $2,000 (160 shares times $12.50 per share).

Most mutual funds report average basis information on transaction statements sent to investors, so there may be no need to make any calculations. However, the taxpayer must make the notation *average basis method* on the line of Schedule D where the gain or loss is reported. He or she must then use the average basis method for all *future* sales of shares in that particular fund.

Specific ID

Using this method, the client specifies exactly which shares he or she wants to sell by reference to the acquisition date and per-share price. Most mutual funds require written instructions by letter or fax. According to the IRS guidelines, the fund or broker must then follow up by confirming the client's instructions in writing. The specific ID method allows the client to sell the most expensive shares to minimize his or her gain. Remember, the client must take action at the time he or she makes the sale. If he or she waits until tax return time to get interested in this idea, he or she will have missed the boat. As previously stated, if a written confirmation from a fund or broker is not available, it is sufficient for the client to give oral instructions regarding the shares she wants to sell,[16] and the client should maintain a log of his or her tax records. That said, written confirmations are always the best proof, when available.

Example 1-5

Use the facts from examples 1-3 and 1-4, except the client now specifies he is selling 100 shares from the second block (costing $15 each) and 60 from the first (costing $10 each).

Using the specific ID method to calculate his gain or loss, the basis of the shares sold is $2,100 ([100 × $15] + [60 × $10]). Now the capital gain is now only $700—$2,800 proceeds, less basis of $2,100.

[16] See *Concord Instruments Corp.*, TC Memo 1994-248 (1994).

Mutual Fund Aggregate Basis Worksheet

The original cost (including brokerage fees, transfer charges, and load charges) of the shares is the starting point for keeping track of the aggregate tax basis of an investment in a particular mutual fund.

1. Enter the original cost amount. ____________

Now make the following adjustments:

2. Increase basis by the amount of reinvested distributions. + ____________
3. Increase basis by the amount of long-term capital gains retained by the fund, as reported on Form 2439 (Notice to Shareholder of Undistributed Long-Term Capital Gains) (this is fairly rare). + ____________
4. Decrease basis by the amount of fund-level taxes paid on long-term gains retained by the fund, as reported on Form 2439 (again, fairly rare). – ____________
5. Decrease basis by the amount of basis allocable to shares already sold. (See the following worksheet for the basis of shares sold using the average cost method.) – ____________
6. The result is the aggregate tax basis of the remaining fund shares. If one sells one's entire holding in the fund, subtract this aggregate basis figure from the net sales proceeds to calculate the gain or loss. (If one sells some but not all of one's shares, see the following worksheet to figure the capital gain or loss.) = ____________

Mutual Fund Capital Gain or Loss Worksheet Using Average Basis Method

Use this worksheet to calculate gain or loss each time an investor sells some but not all of his or her shares in a particular fund for which the average basis method is used. (If the investor sells all his or her shares in the same transaction, skip lines 2–4, and simply enter the amount from line 1 directly on line 5.)

1. Aggregate basis of shares in this fund at the time of sale (from the previous worksheet). ____________
2. Number of shares owned just before selling. ____________
3. Divide line 1 by line 2. This is the average basis ____________
4. Number of shares sold in this transaction. ____________
5. Multiply line 3 by line 4. This is the basis of the shares that were sold, using the average basis method. ____________
6. Total sales proceeds (net of commissions). ____________
7. Subtract line 5 from line 6. This is the taxable capital gain or loss. ____________

Foreign Taxes on International Funds

If a client invests in international mutual funds, his or her year-end statements may reveal that some foreign taxes were paid. The client can either deduct his or her share of those taxes (on Schedule A) or claim a credit against his or her U.S. taxes. Generally, taking the credit is the best option. To take a credit above $300 ($600 for a joint return), the Form 1116 (Foreign Tax Credit) must be filed. The process is not fun, and the client will need to use the information provided by his or her fund on the amounts of foreign income and the related taxes. If the client has smaller amounts of foreign taxes (no more than $300 or $600 if filing jointly) solely from interest and dividends (such as via international mutual funds), the credit can be entered directly on the appropriate line on page 2 of Form 1040 (U.S. Individual Income Tax Return) without filing Form 1116.[17]

Netting Rules and Dispositions of IRC Section 1231 Property Through 2012

When the taxpayer has IRC Section 1231 gains treated as long-term capital gains in more than 1 rate group, there is a favorable "ordering rule" per IRS Notice 97-59 and Treasury Regulation 1.453-12(d), example 4. The amount treated as ordinary income because the IRC Section 1231(c) "nonrecaptured loss rule" will first recharacterize any IRC Section 1231 gain in the 25 percent group, then any net IRC Section 1231 gain in the 15 percent group. If the taxpayer has nonrecaptured IRC Section 1231 losses from the preceding 5 years and is considering selling property that would generate IRC Section 1231 gains, the least "damage" is done by selling gain property in the 25 percent group, then gain property in the 15 percent group.

IRC Section 1231 gains that translate into capital gains in the 25 percent rate group are offset by IRC Section 1231 losses on page 1 of Form 4797. Thus, selling IRC Section 1231 loss property can reduce the amount of gain in the 25 percent rate group.

Converting Capital Gains and Qualified Dividends Into Ordinary Income to Maximize Investment Interest Writeoffs

Individuals incurring investment interest expense must include Form 4952 (Investment Interest Expense Deduction) with their returns. The form limits the itemized deduction for investment interest to the amount of "investment income" from interest, short-term capital gains, and so on.[18] If there is insufficient investment income, the taxpayer can elect to make

[17] See IRS Publication 514, *Foreign Tax Credit for Individuals*, for help in preparing Form 1116 (Foreign Tax Credit).

[18] IRC sec. 163(d).

up some or all of the difference by treating a designated amount of long-term capital gain or qualified dividends as investment income taxed at ordinary rates.[19]

The election is made by reporting the amount of long-term capital gain or qualified dividends to be treated as investment income on Form 4952 (the same number is then entered on Schedule D). The amount of gain or qualified dividends so treated can be as much or as little as the taxpayer wishes, but any gain must come from investment assets rather than business assets or rental real estate.[20] In other words, the gain cannot be IRC Section 1231 gain treated as long-term capital gain. The taxpayer then has that much more investment income, which allows the deduction of that much more investment interest expense.

If the election is made for 2011 or 2012 capital gains, capital gains qualifying for the 15 percent rate are converted before gains taxed at 28 percent. Most taxpayers will not actually have any 28 percent gains, and gains qualifying for the 25 percent rate do not come into play here because they are from IRC Section 1231 property.

When 15 percent gains are converted for 2011 and 2012, taxpayers in the 25 percent bracket essentially pay a 10 percent tax for the privilege of deducting more investment interest currently, those in the 28 percent bracket pay 13 percent, those in the 33 percent bracket pay 19 percent, and those in the 35 percent bracket pay 20 percent.

How to Make the Election

For 2011 returns, the election is made by reporting the elected amount (that is, the amount of qualified dividend income, net capital gain, or both to be treated as investment income taxed at ordinary rates) on Line 4g of Form 4952. The elected amount is then "backed out" of the amounts eligible for preferential tax rates via calculations made on those fun-filled Schedule D worksheets.

According to the 2011 Form 4952 instructions, the elected amount indicated on Line 4g is normally deemed to come first from the taxpayer's net capital gain from property held for investment (shown on Line 4e), and then from qualified dividend income (shown on Line 4b). However, per the instructions, the taxpayer can choose different treatment by making a notation on the dotted line to the left of the box on Line 4e.

> **Key Point:** According to Treasury Regulation 1.163(d)-1, the election can only be revoked with IRS consent.

Election Is Not a No-Brainer

The following examples illustrate that making the election is not always advisable.

Example 1-6

Buck (a 28 percent bracket taxpayer) has $6,000 of 2012 investment interest expense, but his investment income from interest and short-term capital gains is only $2,500. He also has several big 15 percent

[19] IRC sec. 163(d)(4)(B).

[20] IRC sec. 163(d)(5).

long-term capital gains from stock and mutual fund transactions. Making the election to convert $3,500 of capital gain into investment income lets Buck deduct all his investment interest. At a marginal rate of 28 percent, $980 comes off his 2012 tax bill.

However, he would also pay an extra 13 percent on $3,500 worth of converted 15 percent gains ($455).

The net tax savings are $525, so Buck realizes only a net 15 percent tax benefit from the bigger deduction. (A net 15 percent benefit results regardless of his marginal rate as long as it is 25 percent or higher.)

Clients with situations similar to example 1-6 should consider passing on the election. The 2012 excess investment interest expense ($3,500 in Buck's case) will carry over into 2013 when he may have enough investment income to fully deduct the carryover, plus any investment interest incurred this year.

If 2013 investment income is high enough, the client will realize a 25 percent, 28 percent, 33 percent, or 35 percent tax benefit from the carryover without paying any extra tax on his or her 2012 capital gains. (This assumes no change in the rate structure. Of course, there is a time value of money advantage to making the election and claiming a bigger 2012 investment interest expense deduction, but a bigger 2013 tax benefit might more than make up the difference.

Example 1-7

Use the same facts as in example 1-6, except now Buck carries over the $3,500 excess investment interest and deducts it in 2013. (Buck already knows he will have plenty of 2013 investment income, because he has decided the stock market is overvalued and has therefore allocated a bigger percentage of his investment assets to taxable bonds.)

Assuming the 28 percent marginal rate still applies to Buck in 2013, the 2013 deduction saves him $980 in 2013 in exchange for leaving $525 on the table in 2012.

Of course, if the client cannot foresee having enough investment income anytime soon, he or she should go ahead and make a current-year election to convert enough long-term capital gain to fully deduct the amount of current-year investment interest expense. As example 1-6 illustrates, this results in only a 15 percent net tax benefit (through 2012), but that is better than waiting indefinitely for the writeoff.

Special Breaks for Sales of QSBC

QSBCs are a special category of C corporation, the stock of which can potentially qualify for (1) a gain exclusion break and (2) a gain rollover break. When QSBC status is available, these breaks can make operating as a C corporation a tax-smart alternative to the conventional wisdom that operating as a pass-through entity is always best. This section will discuss gain exclusion rules and the related AMT preferences rules, which have both become moving targets in recent years.

General 50 Percent Gain Exclusion Rule

Under the general rule, when a C corporation meets the definition of a QSBC, shareholders (other than C corporations) are potentially eligible to exclude from taxation up to 50 percent of their gains on sale of the corporation's stock.

Special 75 Percent Gain Exclusion Rule

The American Recovery and Reinvestment Act of 2009 (better known as the stimulus act) increased the gain exclusion percentage from the longstanding 50 percent to 75 percent (within the limits explained subsequently). However, this beneficial change only applies to sales of QSBC shares that are issued between February 18, 2009, and December 31, 2010.

> **Key Point:** Do not get too excited about this change. Because a 5-year holding period rule must be satisfied before the 75 percent gain exclusion privilege is available, this only affects sales that will occur in 2014 and beyond. For other sales of QSBC shares (such as sales that occur before 2014), the general 50 percent gain exclusion rule will still apply.[21]

Extra-Special 100 Percent Gain Exclusion Rule

The Small Business Jobs Act of 2010 allows a 100 percent gain exclusion (within the limits explained subsequently) for sales of QSBC shares issued between September 28, 2010, and December 31, 2010. In addition, excluded gains from selling such shares do not count as an AMT preference item.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the window for taking advantage of the preceding two changes by one year, to cover QSBC shares issued in calendar year 2011. Therefore, qualifying gains from QSBC shares issued between September 28, 2010, and December 31, 2011, are eligible for the 100 percent gain exclusion, and there is no AMT preference for such gains.[22]

> **Key Point:** Once again, do not get too excited about these changes. QSBC stock must still be held for more than five years for the gain exclusion break to be available, so these changes only affect sales that will occur after September 28, 2015, at the earliest.

Gain Exclusion Basics

IRC Section 1202 contains the rules that must be met for stock to meet the definition of QSBC stock and thereby be eligible for the 50 percent, 75 percent, or 100 percent gain exclusion. Limitations also exist on the total amount of gain that is eligible for the gain exclusion privilege. These *eligible gain* limitations are discussed in more detail later in this chapter.

However, the single most important qualification rule is that the stock must have been issued to the selling shareholder on or after August 11, 1993, and have been held for more

[21] See IRC sec. 1202(a)(3).

[22] See IRC sec. 1202(a)(3) and (4).

than five years. Advisers should *carefully* review IRC Section 1202 before concluding a corporation will meet the definition of a QSBC.

No special election or other action is necessary to take advantage of the QSBC break. Stock will either qualify as QSBC stock in the hands of shareholders or not. QSBCs are treated as "regular" C corporations for all other legal and federal tax purposes; as a result, all the other advantages and disadvantages of C corporation status apply equally to QSBCs.

Unfortunately, the Bush tax cut capital gains rate reductions for individual taxpayers were not extended to the taxable portion of eligible gains from sales of QSBC stock qualifying for the 50 percent, 75 percent, or 100 percent gain exclusion benefit. Instead, the taxable portion of eligible gains from such stock sales remains subject to the pre-Bush 28 percent maximum rate.[23] This generally translates into an effective rate of either 14 percent (under the 50 percent gain exclusion deal), 7 percent (under the 75 percent exclusion deal), or 0 percent (under the 100 percent gain exclusion deal) on eligible gains.

The following tables show the combined effective tax rate on a QSBC's taxable income assuming the income (net of tax) is retained and adds to the value of the corporate stock dollar for dollar. The stock is assumed to be sold for an eligible gain that is taxed at an effective rate of 14 percent, 7 percent, or 0 percent (after the exclusion of 50 percent, 75 percent, or 100 percent of the gain). The combined effective rates should be compared to the marginal individual rate (which can be as high as 35 percent and possibly higher after 2012) that would apply if the income were instead earned by a pass-through entity.

Qualified Small Business Corporation (QSBC) Average Tax Rate	Individual Rate on Gains	Combined Rate
15.00%*	14%	26.9%
18.33%†	14%	29.8%
34.00%‡	14%	43.2%
QSBC Average Tax Rate	**Individual Rate on Gains**	**Combined Rate**
15.00%*	7%	20.95%
18.33%†	7%	24.05%
34.00%‡	7%	38.62%
QSBC Average Tax Rate	**Individual Rate on Gains**	**Combined Rate**
15.00%*	0%	15.00%
18.33%†	0%	18.33%
34.00%‡	0%	34.00%

Observation: If the time value of money is taken into account, the combined rates in the first two cases shown in this chart will be reduced by a bit because the capital gain component (the 14 percent or 7 percent rate) of the combined rate on qualified small business corporation income is deferred until the stock is sold. In contrast, taxes on pass-through income must be paid currently.

* 15 percent average rate applies to taxable income up to $50,000.

† 18.33 percent average rate applies to taxable income of $75,000.

‡ 34 percent average rate applies to taxable income between $335,000 and $10 million.

[23] IRS Notice 97-59.

Example 1-8

Mom's Creamery is expected to generate taxable income of $75,000 per year. Mom intends to operate the venture for a little more than 5 years and then sell out. Because she has income from other sources, the incremental income from the new creamery business would be taxed at 35 percent (maybe higher in post-2012 years) if a sole proprietorship or pass-through entity is used. However, if Mom sets up shop as a C corporation and the entity meets the definition of a QSBC, the corporate-level tax on projected income will be only 18.33 percent, and Mom can exclude 75 percent of her gain when she sells her stock. (The shares were issued to Mom between February 18, 2009, and December 31, 2010.)

If the corporation's retained after-tax income adds to the value of its stock dollar for dollar. After 5 years, Mom will pay a 7 percent long-term capital gain tax (after the 75 percent gain exclusion for QSBC stock) on 85 percent of the corporation's taxable income.

This amounts to an effective shareholder-level tax rate of 5.72 percent (7 percent of 81.67 percent) on top of the corporate-level tax of 18.33 percent. The combined shareholder-level and corporate-level tax bite is therefore only 24.05 percent (5.72 percent plus 18.33 percent). This is significantly lower than the 35 percent maximum rate (maybe higher after 2012) that would apply to a high-income owner if a sole proprietorship or pass-through entity is used for the same business.

In addition, if the time value of money is taken into account, the combined effective rate for QSBCs is even lower, because the capital gain component (the 5.72 percent rate) is deferred until Mom sells her stock. In contrast, the full 35 percent tax bite (maybe higher) is due annually if a pass-through entity or sole proprietorship is used.

AMT Preference for Pre-2013 Sales

Unfortunately, there is a lump in the QSBC gravy. For AMT purposes, 7 percent of the excluded QSBC gain from a pre-2013 sale, which is usually, but not always 50 percent of the total gain, is treated as a tax preference item under IRC Section 57(a)(8). The 7 percent preference amount only applies to sales through the end of 2012. Therefore, if exactly 50 percent of the total gain is excluded (the eligible gain limitation rules are explained subsequently), and the entire amount of the preference (7 percent of 50 percent) is taxed at the applicable AMT rate of 26 percent or 28 percent, the effective tax rate on the total gain from a pre-2013 sale will be between 14.91 percent and 14.98 percent. Obviously, this is only a microscopic improvement over the 15 percent maximum rate that would apply to a pre-2013 long-term capital gain in the absence of the QSBC rules.

On the other hand, for taxpayers who are not subject to the AMT, a 14 percent effective rate on QSBC stock sale gains (after the 50 percent exclusion) still looks better than the 15 percent rate that will generally apply to long-term gains from pre-2013 sales of garden-variety stock.

AMT Preference for Post-2012 Sales

As the law currently reads, the AMT preference will generally increase to 28 percent for QSBC stock sales that occur after December 31, 2012. This is part of the scheduled "sunset" of the Bush tax cuts. Therefore, if exactly 50 percent of the total gain from a post-2012 QSBC stock sale is excluded, and the entire amount of the preference (28 percent of 50 percent) is taxed at the 26 percent or 28 percent AMT rate, the effective tax rate on the total

gain will be between 17.64 percent and 17.92 percent. These rates are only microscopically better than the scheduled 18 percent maximum rate on gains from sales of garden-variety stock that has been held for more than 5 years.

If exactly 75 percent of the total gain from a post-2012 QSBC stock sale is excluded, because the shares were issued between February 18, 2009, and December 31, 2010, and the entire amount of the preference (28 percent of 75 percent) is taxed at the 26 percent or 28 percent AMT rate, the effective tax rate on the total gain will be between 12.46 percent and 12.88 percent. These rates are significantly better than the scheduled 18 percent maximum rate on gains from sales of garden-variety stock that has been held for more than 5 years.

If exactly 100 percent of the total gain from a post-2012 QSBC stock sale is excluded, because the shares were issued between September 28, 2010, and December 31, 2011, and there is no AMT preference, the effective tax rate on the total gain will 0 percent. Obviously, that is much better than the scheduled 18 percent maximum rate on gains from sales of garden-variety stock that has been held for more than 5 years.

Example 1-9

Mom invested $75,000 in Mom's Creamery, Inc. shares that qualify for the 50 percent QSBC gain exclusion. After holding them for more than 5 years, she sells the shares for $125,000. Mom can exclude 50 percent of the total $50,000 gain ($25,000), and she will pay a maximum regular tax rate of 28 percent on the remaining $25,000 of gain. Assuming the AMT preference for the year of sale is 28 percent of the excluded gain, Mom will have an AMT preference item of $7,000 (28 percent of the $25,000 excluded gain amount). However, if the preference item does not actually push Mom into the AMT mode, she will pay only $7,000 of regular tax on the $50,000 gain ($25,000 taxable gain × 28 percent tax rate = $7,000), for an effective tax rate of only 14 percent on the total gain ($7,000/$50,000 = 14 percent).

Variation

Use the same basic facts, except that now Mom's gain qualifies for the 75 percent QSBC gain exclusion. Mom can exclude 75 percent of the total $50,000 gain ($37,500), and she will pay a maximum of 28 percent on the remaining $12,500 of gain. Assuming the AMT preference for the year of sale is 28 percent of the excluded gain, Mom will have an AMT preference item of $10,500 (28 percent of $37,500). However, if the preference item does not actually push Mom into the AMT mode, she will pay only $3,500 of regular tax on her $50,000 gain ($12,500 taxable gain × 28 percent tax rate = $3,500), for an effective tax rate of only 7 percent on the total gain ($3,500/$50,000 = 7 percent).

Key Point: Under the current individual federal income tax rate structure (which may not last beyond 2012), the 50 percent QSBC stock sale gain exclusion break is all but meaningless for clients who are solidly in the AMT mode. Even for clients who are blissfully unaffected by the AMT, the 50 percent gain exclusion break translates into a 14 percent effective tax rate, which is only 1 percentage point below the current 15 percent maximum tax rate on garden-variety long-term capital gains. Depending on what happens to tax rates on post-2012 long-term gains, the 75 percent gain exclusion break may or may not be very meaningful. Of course, the 100 percent gain exclusion break will be a heck of a deal for anyone who qualifies. In any case, however, the QSBC stock sale gain rollover provision explained later in this chapter will be a valuable tax break.

Limitations on QSBC Gain Exclusion

There are limits placed on the total amount of gain that is eligible for the 50 percent, 75 percent, or 100 percent gain exclusion break.[24] This total amount of gain that qualifies for the applicable gain exclusion percentage is called the *eligible gain*.

In any taxable year, the *eligible gain* is limited to the *greater* of

- 10 times the taxpayer's aggregate adjusted basis in the qualified small business stock that is sold or
- $10 million reduced by the amount of eligible gain taken into account in prior taxable years for dispositions of stock issued by the corporation ($5 million for married filing separate status).

If the taxpayer contributed appreciated property for his or her QSBC stock, the property's basis is considered to be the fair market value (FMV) on the contribution date for purposes of computing the gain potentially eligible for exclusion and for applying the 10 times the stock basis limitation rule.[25]

In effect, the second limitation is a lifetime limitation. It applies to the cumulative gains recognized by the taxpayer from dispositions of stock in a particular QSBC. There is no carryover of gain amounts in excess of the limitation amount.

> **Key Point:** The amount of eligible gain that cannot be excluded (which means either 50 percent or 25 percent of the eligible gain) is the amount that is subject to the aforementioned 28 percent maximum federal tax rate.[26]

Example 1-10

Mom is a married taxpayer filing a joint return, and her eligible gain is limited by the $10 million rule for the taxable year in question. Under that limitation, the maximum amount of gain that she can exclude in the taxable year under the 50 percent, 75 percent, or 100 percent exclusion deal is $5 million, $7.5 million, or $10 million, respectively.

However, if the 10 times the basis limitation rule gives Mom a better answer, she can use that rule to determine the eligible gain limitation. In that case, there is no dollar cap on the eligible gain. Instead, the limitation on the eligible gain depends on the basis of the stock. See the following examples.

Example 1-11

Mom sells QSBC stock with a basis of $800,000 for a total gain of $20 million. The eligible gain limitation (which means the maximum amount of gain eligible for the 50 percent, 75 percent, or 100 percent exclusion) is the greater of

- $8 million (10 times the $800,000 basis of the stock) or
- $10 million reduced by eligible gains taken into account in prior taxable years (if any).

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[24] IRC sec. 1202(b)(1).

[25] IRC sec. 1202(i)(1).

[26] IRC sec. 1(h)(4)(A)(ii).

Assuming no previous QSBC stock sale gains, Mom's eligible gain limitation is the $10 million figure because that is the greater amount.

Thus, she can exclude $5 million, $7.5 million, or $10 million of gain (that is, 50 percent, 75 percent, or 100 percent of the $10 million eligible gain) in computing her taxable income for the year the stock is sold.

The next $5 million or $2.5 million or $0 of gain (that is, equal to the amount of eligible gain in excess of the excluded amount) will be taxed at 28 percent.

The remaining $10 million of gain (that is, the amount of gain in excess of the eligible gain) will be taxed at the "normal" rate for long-term gains from garden-variety stock sales (currently no more than 15 percent, but who knows for post-2012 sales).

Also, Mom will have an AMT preference item of $0 or $350,000 or $1.4 million or $2.1 million for the year of sale depending on whether there is (*a*) no preference, which applies when the 100 percent gain exclusion is available; or (*b*) the preference equals 7 percent of the excluded gain, which applies to pre-2013 sales; or (*c*) the preference equals 28 percent of the excluded gain, which generally applies to post-2012 sales.

If the entire preference amount is taxed at the highest AMT rate of 28 percent, she could owe AMT of $392,000 (0.28 × $1.4 million preference) or $588,000 (0.28 × $2.1 million preference) on a post-2013 gain. The AMT bill would be on top of the regular federal income tax bill.

When all is said and done, Mom's regular federal income tax hit on the $20 million total gain will equal (*a*) 0 percent times the excluded amount of gain ($5 million, $7.5 million, or $10 million), plus (*b*) 28 percent times the eligible gain in excess of the excluded amount ($5 million or $2.5 million or $0), plus (*c*) the "regular" long-term rate times the remaining $10 million of gain (the amount of gain in excess of the eligible gain).

In addition, she will probably owe a significant amount of AMT. Whether this will work out to be a significantly better deal than the tax hit on a $20 million long-term gain from a garden-variety stock sale remains to be seen. It depends on the tax rates and rules that will apply for the year of sale.

As example 1-11 shows, the savings from the 50 percent or 75 percent gain exclusion may be minimal or greatly reduced for large gains, because the AMT preference item may cause most or all of the excluded gain to be taxed at the AMT rate of 26 percent or 28 percent. The additional AMT liability will then offset part of (or maybe almost all of) the regular tax savings from the gain exclusion. In reality, the gain rollover privilege explained later may sometimes have more value than the gain exclusion.

Example 1-12

Mom sells QSBC stock with basis of $2 million for a total gain of $11 million. In earlier years, she had taken eligible gains of $4 million into account and she had excluded $2 million under the 50 percent gain exclusion deal. For the current sale, the eligible gain limitation (meaning the maximum amount of gain that is eligible for the 50 percent, 75 percent, or 100 percent gain exclusion privilege) is the greater of

- $20 million (10 times the basis) or
- $6 million ($10 million less the $4 million already "used up" in Mom's prior tax years).

Thus, Mom's entire $11 million gain qualifies as eligible gain (under the 10 times the basis limitation). Therefore, she can exclude either $5.5 million or $8.25 million or $11 million (that is, 50 percent, 75 percent, or 100 percent of the $11 million gain). If the 50 percent or 75 percent gain exclusion rule applies,

the remaining $5.5 million or $2.75 million of gain (that is, equal to the amount of eligible gain in excess of the excluded gain amount) will be taxed at 28 percent, and Mom will have an AMT preference item equal to either 7 percent or 28 percent of the excluded gain amount.

Gain Rollover Rule

There is also a gain rollover rule for QSBC stock that applies to gains realized by an individual taxpayer if the taxpayer elects gain rollover treatment.[27] Under the rule, the amount of gain recognized is limited to the excess of QSBC stock sales proceeds over the amount reinvested to purchase other QSBC shares (replacement stock) during a 60-day period beginning on the date of sale. The rolled over gain reduces the basis of the replacement stock. (Gain that would be treated as ordinary income does not qualify for rollover.) The selling taxpayer must not be a C corporation, and the QSBC stock that is sold must have been held more than 6 months.

If the replacement stock qualifies as QSBC stock when sold, under the IRC Section 1202 qualification rules, the 50 percent, 75 percent, or 100 percent gain exclusion is available provided the 5-year holding period rule is met. The holding period of the stock sold in the rollover transaction is added to the holding period of the replacement stock.[28]

The gain rollover provision essentially allows an investor to sell QSBC shares on a wholly or partially tax-deferred basis without meeting the 5-year holding period rule, while remaining eligible for the 50 percent or 75 percent, or 100 percent gain exclusion on the eventual sale of the replacement stock.

Example 1-13

Mom was issued 200 shares in Mom's Creamery, Inc. (Creamery) on June 15, 2009. She paid $50,000 for the stock. The shares met the definition of QSBC stock throughout Mom's holding period, which ended when she sells the stock for $400,000 on September 15, 2011. Mom thus realizes a $350,000 gain. Within 60 days, she pays $450,000 for newly issued shares of Mom's Old-Fashioned Yogurt, Inc. (Yogurt). Mom elects to roll over all of her Creamery gain by reducing the basis of her new Yogurt shares to $100,000 ($450,000 cost less $350,000 gain rollover).

Mom's holding period for the Yogurt shares begins on June 16, 2009, because the holding period of her Creamery shares is tacked on. Thus, she will be eligible to take advantage of the 75 percent gain exclusion deal if she sells the Yogurt shares after June 15, 2014, assuming the shares continue to meet the definition of QSBC stock. Alternatively, she could sell her Yogurt shares before that date (or after) and roll over some or all of the gain by purchasing another round of QSBC replacement stock.

[27] IRC sec. 1045.

[28] IRC sec. 1223.

Qualification Rules for QSBC Gain Exclusion and Gain Rollover Privileges

To qualify for (1) the 50 percent, 75 percent, or 100 percent gain exclusion privilege or (2) the gain rollover privilege, the stock must constitute "eligible stock" by meeting all of the following requirements:

- The stock must be acquired by the taxpayer after August 10, 1993.
- The taxpayer must generally acquire the stock upon its original issuance (that is, either directly or through an underwriter) or through gift or inheritance.
- The stock must be acquired in exchange for money, other property (not including stock), or services (not including services performed as an underwriter).

In order for the 50 percent, 75 percent, or 100 percent gain exclusion to be available, the corporation must be a QSBC at the date of the stock issuance and during substantially all the period the taxpayer holds the stock. The following requirements must be satisfied in order for a corporation to constitute a QSBC:

- It must be a C corporation.
- It cannot be (*a*) a domestic international sales corporation (DISC) or a former DISC, (*b*) an IRC Section 936 corporation or a corporation with an IRC Section 936 subsidiary, (*c*) a regulated investment company, (*d*) a REIT, (*e*) a real estate mortgage investment conduit, or (*f*) a cooperative.
- It cannot own either (*a*) real property with a value that exceeds 10 percent of its total assets or (*b*) portfolio stock or securities with a value that exceeds 10 percent of its net worth.

To be a QSBC, the corporation must also satisfy an active business requirement. The active business requirement is deemed satisfied, if either

- the corporation is a specialized small business investment company licensed by the Small Business Administration (unlikely) or
- at least 80 percent (by value) of the corporation's assets (including intangible assets) are used by the corporation in the active conduct of a qualified trade or business.

For this purpose, qualified businesses do *not* include

- the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services or any other trade or business in which the principal asset is the reputation or skill of one or more of its employees;
- banking, insurance, leasing, financing, investing, or similar activities;
- farming;
- production or extraction of oil, gas, or other natural resources; or
- operation of a hotel, motel, restaurant, or similar business.

Finally, the corporation's gross assets cannot exceed $50 million on the date of the stock issuance. For purposes of this rule, the values of the corporation's assets are generally based on their adjusted basis to the corporation. However, contributed property is valued at FMV at the time of its contribution. If a corporation meets the gross assets test on the date of a stock issuance, a subsequent increase in the value of its assets will not cause such test to be failed. Conversely, once the $50 million threshold is exceeded, the corporation can never again be a QSBC, even if its assets subsequently fall below $50 million.

Planning for Capital Gain Treatment for Subdivided Lot Sales

When a landowner subdivides a parcel to sell off individual lots, he or she is generally considered a real estate dealer, and the lots represent *inventory*. As a result, gains from the lot sales are taxed as ordinary income.

Fortunately, IRC Section 1237 provides an exception to ordinary income treatment. Subject to the limitations explained subsequently, the seller will *not* be considered a dealer merely because the land has been subdivided into lots; of advertising, promotion, or selling activities; or of the use of sales agents.

In other words, if the seller was holding the land for investment, subsequent subdividing and selling activities *will not* cause the property to be transformed into inventory, and the seller can still take advantage of the 15 percent maximum rate (for 2010) on capital gains from sales of lots held more than 12 months.

Restrictions on IRC Section 1237 Relief

Congress has imposed the following restrictions on the availability of IRC Section 1237 relief.

1. Relief is unavailable to taxpayers whose activities with respect to their other land holdings indicate they are real estate dealers.[29]
2. Relief is generally unavailable to C corporation sellers.[30] However, it is available to individuals, partnerships, limited liability companies (LLCs) treated as partnerships for federal income tax purposes, and S corporations.
3. The seller must have held the property for at least five years unless it was inherited. However, under IRC Section 1223, the seller's holding period may include that of a previous owner in certain circumstances.[31]
4. The land in question must be a *tract of real property* as defined by IRC Section 1237(c) and Treasury Regulation 1.1237-1(g).
5. The seller cannot have ever held any portion of the land for sale in the ordinary course of business (in other words, as inventory); and in the year of sale, the seller cannot hold any other real property primarily for sale in the ordinary course of business.

[29] Treas. Reg. 1.237-1(a).

[30] IRC sec. 1237(a).

[31] See examples in Treas. Reg. 1.1237-1(b) and (c).

6. The seller cannot have made any substantial improvements that materially increased the value of the lots that are sold, nor can such improvements be made pursuant to the contract for sale between the seller and buyer. Improvements made by certain related parties (such as a controlled corporation) are considered made by the seller.[32]
7. After more than five lots from the same tract have been sold, gains from lot sales in the year the sixth lot is sold, and in later years, are ordinary income to the extent of 5 percent of the sales price for those lots.[33]

For purposes of the preceding rules, the seller is treated as holding other real estate owned individually, jointly, indirectly as a member of a partnership or LLC, or indirectly as an S corporation shareholder.[34] However, the seller is generally not treated as indirectly holding other real estate owned by family members, estates, trusts, or C corporations.[35]

Example 1-14

Wayne, who is not a real estate dealer, is a member of an LLC engaged in real estate development. For purposes of this example, the LLC is a dealer because it holds real estate primarily for sale in its development business. During the year, Wayne subdivides a tract he has owned for many years and sells off four lots for large gains.

Unfortunately, Wayne is treated as an owner of the LLC's real estate and is therefore disqualified from IRC Section 1237 relief (see item 5 in the previous list). As a result, Wayne's lot sale gains will be taxed as ordinary income.

However, if the real estate development entity was a C corporation (rather than an LLC) and Wayne was a shareholder, his indirect ownership of the C corporation's real estate would not disqualify him from IRC Section 1237 relief. In this circumstance, Wayne could treat his lot sale gains as long-term capital gains subject to the 15 percent maximum rate (through 2012), assuming he also meets all the other IRC Section 1237 requirements.

Example 1-15

Belinda, who is a real estate dealer, sells four subdivided lots from a single tract she owns.

Because Belinda is a dealer during the year she sells the lots, IRC Section 1237 relief is unavailable (see item 1 in the previous list). Accordingly, she will have to pay ordinary income rates on her lot sale gains.

Example 1-16

Victoria's rich Uncle Dudley gave her a small but valuable real estate tract as a gift. Uncle Dudley made his millions as a real estate developer. He held the tract for four years and intended to subdivide the property and sell off lots in the ordinary course of his business.

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[32] IRC sec. 1237(a)(2)(A) and Treas. Reg. 1.1237-1(c).

[33] IRC sec. 1237(b).

[34] Treas. Reg. 1.1237-1(b)(3) and Committee Reports on §1314 of Small Business Protection Act of 1996.

[35] Treas. Reg. 1.1237-1(b)(3).

Victoria holds the tract for three years and then subdivides the parcel. She succeeds in selling three lots for large gains.

Under IRC Section 1223, Victoria's holding period for the property includes her Uncle Dudley's holding period because she received the tract as a gift. Victoria therefore meets the five-year rule.

However, the regulations state that she is disqualified from IRC Section 1237 relief because of Uncle Dudley's motive for owning the property, unless Victoria can demonstrate that she did not also hold the tract primarily for sale in the ordinary course of business.[36] (Apparently, Victoria could prove this by showing she intended to hold the tract for investment for several years before later deciding to subdivide the property and sell it off as lots.)

Example 1-17

Rhonda is a CPA who sometimes buys raw land for investment. She has no other activities that would indicate she is a real estate dealer. During the year, Rhonda sells three tracts acquired five years ago for substantial profits.

She can treat the gains as long-term capital gains and pay a maximum tax rate of 15 percent (through 2012). Rhonda does not need IRC Section 1237 relief (nor does she qualify for it), because the tracts were investment property and were not subdivided and sold off as lots.

The same result would apply if Rhonda is considered a dealer in real estate, as long as she can prove her reason for holding the three tracts in question was for investment rather than primarily for sale in her business as a real estate dealer.

Definition of Tract of Real Property

IRC Section 1237 relief is available only if the subdivided land constitutes a *tract of real property*. (See item 4 in the previous list.) In general, this means a single piece of real estate. However, two or more pieces can qualify if at any time they were contiguous (that is, having a common boundary at one or more points) in the hands of the seller *or* if the pieces would be contiguous but for a road, street, railroad, stream, and so on.[37]

A tract of real property can be assembled from acquisitions at various times, and the seller can treat contiguous pieces as a single tract even though some pieces are owned individually, some jointly, and some indirectly as a partner, member of an LLC, or for tax years beginning after 1996 as an S corporation shareholder.

For counting purposes under the *five lot rule* (see item 7 in the previous list), the remaining lots in a tract of real property constitute a new tract after one or more lots have been sold from the original tract and five years have passed since the last sale from the original tract.

Definition of Substantial Improvement

Per item 6 in the previous list, the lot seller cannot make *substantial improvements* that *substantially increase* the value of the lots. Similarly, such improvements cannot be made under the

[36] Treas. Reg. 1.1237-1(b)(3).

[37] IRC sec. 1237(c) and Treas. Reg. 1.1237(g)(1).

terms of the contract for sale between the seller and buyer. Improvements made by certain related parties (such as the seller's controlled corporation) are considered made by the seller.[38]

To restate the rule, improvements result in disqualification for IRC Section 1237 relief only if (1) they are substantial in character *and* (2) they substantially enhance the value of the lot that is sold. Under the regulations, substantial improvements include commercial or residential buildings; hard surface roads; and sewer, water, gas, and electric lines. Examples of insubstantial improvements include a temporary structure used as a field office; surveying, filling, draining, leveling, and clearing operations; and minimum all-weather access roads, including gravel roads when required by the climate.[39]

Even substantial improvements will not disqualify the seller from IRC Section 1237 relief for a particular lot sale unless it also directly and substantially enhances the value of that specific lot. What is *substantial*? According to Treasury Regulation 1.1237-1(c)(3), an increase of 10 percent or less is insubstantial, and when improvements increase value by more than 10 percent, all relevant factors should be examined to determine if the increase is substantial.

Under these rules, the values of particular lots could be substantially increased by improvements, while the values of other lots are not. Therefore, some lots may become ineligible for IRC Section 1237 relief, while certain other lots in the same tract still qualify.

Example 1-18

Vern made major improvements to a tract he had owned for two years. He then made a gift of the property to his son Delgado. Four years later, Delgado subdivided the tract and began selling off lots.

Vern's improvements substantially enhanced the value of the lots. Delgado is therefore ineligible for IRC Section 1237 relief because he is treated as having made the improvements that Vern paid for (see item 6 in the previous list).

Election to Disregard Substantial Improvements

Individual taxpayers may be eligible for a special election to treat otherwise disqualifying improvements as not being substantial.

Requirements

The election is available if all the following requirements are met:

1. The seller agrees to *not* deduct the costs of the improvements or add the costs to the basis of the lot or lots sold.
2. The seller has held the property for 10 years (not counting ownership by the previous owner if the property was inherited).
3. The improvements are limited to roads (including hard surface roads), curbs, and gutters and water, sewer, and drainage facilities (including both surface and subsurface facilities).

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[38] IRC sec. 1237(a)(2)(A) and Treas. Reg. 1.1237-1(c)(2).

[39] Treas. Reg. 1.1237-1(c)(4).

4. The IRS district director is satisfied that the improvements are necessary to bring the FMV of the lot (or lots) up to the prevailing value for similar sites in the local area. The specifics on how to make this election are covered in Treasury Regulation 1.1237-1(d)(iii). Obviously the election is advisable only when the tax savings from IRC Section 1237 relief outweigh the tax detriment of ignoring the improvement costs.

Situations in which the election could make sense include the following:

1. The seller has capital loss carryovers that will shelter all or part of the capital gain from selling the lots (without IRC Section 1237 relief, capital loss carryovers would not shelter the lot sale gains because the gains would be ordinary income).
2. The gains are large in relation to the improvement costs and the tax savings from the lower 15 percent rate on long-term capital gains (through 2012) outweighs the tax benefit from adding the improvement cost to the basis of the lots.

Keep in mind the election is only available when the improvements are necessary to bring the price of the lots up to the prevailing market. If the seller can get market price without the making the improvements, the election is not an option.

Example 1-19

Tom, who is in the 35 percent marginal tax bracket (through 2012), owns a 5-acre tract of unimproved land in a highly desirable residential area. Tom has owned the land for 14 years, and his basis is only $80,000. He wants to subdivide the property into 5, 1-acre lots, in accordance with the local zoning restrictions.

Unfortunately, Tom's land has some serious (but correctable) drainage problems and is therefore much less valuable than similar nearby unimproved sites. Tom recently received a written offer of $100,000 per acre for his parcel (total of $500,000). Similar nearby improved tracts (with road and drainage improvements) are selling for $200,000 per acre, and the improvements to these similar properties cost an average of about $50,000 per acre.

According to the IRC Section 1237 regulations, this makes the prevailing market price for comparable unimproved acreage about $150,000 per acre ($200,000 less $50,000). If Tom can install a road and correct the drainage problems on all 5 lots for a total of $325,000, the lots could then be sold for around $200,000 each (total of $1,000,000).

Tom's proposed improvements would clearly be substantial in character and result in a substantial increase in the value of the lots. However, based on the offer Tom received, the improvements are needed just to raise the value of the lots to the prevailing level. Therefore, Tom is eligible to make the election to treat the improvements as not substantial and ignore their cost in calculating his gain from sale.

If Tom makes the improvements for the expected cost, sells the lots for the expected price, and makes the election, he will have a long-term capital gain of $920,000 ($1 million sales proceeds less $80,000 basis), and his tax at 15 percent (through 2012) will be $138,000. (The 15 percent rate applies only because the election allows Tom to qualify for IRC Section 1237 relief.) In contrast, if Tom does not make the election, his gain will be only $595,000 ($1 million sales proceeds less basis of $405,000, including the cost of improvements), but the tax on that amount at 35 percent (through 2012) is $208,250.

In this example, making the election saves the taxpayer $70,250 ($208,250-$138,000) based on 2012 tax rates.

The Six-Lot Rule

Under the IRC Section 1237 rules, when more than five lots from the same tract of real property are sold, gains from lot sales in the year the sixth lot is sold and in later years are treated as ordinary income to the extent of 5 percent of the selling price for each affected lot.[40] Note that lot sales in tax years before the sale of the sixth lot are unaffected by this gain recharacterization rule, but if more than five lots are sold in the first year of sales, all sales are affected.

The amount of gain that is recharacterized as ordinary income is limited to the excess (if any) of 5 percent of the selling price over the selling expenses for the lot.[41] The sale of two or more contiguous lots to the same buyer in the same transaction counts as only one lot sale for purposes of the six-lot rule.[42] In addition, the remaining lots in a particular tract of real property constitute a new tract after one or more lots have been sold from the original tract and five years have passed since the last sale from the original tract. Under this *fresh start* provision, the remaining lots need not still be contiguous to qualify as a single new tract.[43]

Example 1-20

Neville has owned a tract of raw land for 6 years. In 2012, he subdivides the property into 12 lots and immediately sells single lots to Horace, Evander, Desiree, and Dolly. At the same time, he also sells three contiguous lots to Emory.

Under the 6-lot rule, Neville is treated as selling only 5 lots because the 3 contiguous lots sold to Emory count as only 1 lot. Assuming Neville meets all the other IRC Section 1237 requirements discussed earlier in this chapter, his lot sale gains are all long-term capital gains eligible for the 15 percent maximum rate.

Neville then waits for 5 years without selling any additional lots.

His remaining 5 lots now constitute a new tract of real property for purposes of the 6-lot rule (even if some 2012 sales caused the remaining lots to be noncontiguous). Neville can then sell the remaining lots without having to worry about the gain recharacterization rule.

Use S Corporation Developer Entity Strategy to Slash Taxes on Appreciated Land

Despite the lousy economy and depressed real estate prices in most areas, some folks are fortunate to still own highly appreciated acreage that is now ripe for development. If your client is one of these people, he or she can cash in by subdividing the acreage, developing the parcels, and selling them off for a large profit. However, that could trigger a whopping tax bill. Not so lucky! Here is the rub: in this scenario, tax law generally deems the client to be real estate "dealer." Therefore, the profit from developing and selling the acreage is

[40] IRC sec. 1237(b).

[41] See Treas. Reg. 1.1237-1(e)(2) for examples of how this limitation is calculated.

[42] Treas. Reg. 1.1237(e)(2).

[43] IRC sec. 1237(c) and Treas. Reg. 1.1237(g)(2).

considered profit from selling "inventory."[44] That means your client's entire profit—including the portion from the pre-development appreciation in the value of the land—will be ordinary income taxed at a marginal federal rate of up to 35 percent (through 2012) plus the state income tax hit, if applicable.

Life would be much sweeter if you could figure out a way for your client to pay long-term capital gains rates on at least part of the profit. The maximum federal income tax rate on long-term capital gains is only 15 percent (through 2012), which is much easier to swallow than 35 percent.

> **Key Point:** If your client's circumstances are just right, he or she might qualify for capital gains treatment under the taxpayer-friendly IRC Section 1237 exception explained earlier in this chapter. However, the IRC Section 1237 break comes with a bunch of restrictions, and many clients will be ineligible.

Thankfully, your client may be able to take advantage of a strategy that allows favorable long-term capital gains treatment for all the pre-development appreciation in the value of the land. This assumes the client has held the land for investment rather than as a dealer in real estate. Note that profit attributable to subsequent subdividing, development, and marketing activities will still be considered ordinary income, because the client will be considered a dealer for that part of the process. However, if the client can manage to pay only 15 percent (through 2012) on the bulk of the profit (the portion from the pre-development appreciation), that is surely something to celebrate.

For example, if the pre-development appreciation in the value of the client's land is $1 million, by employing the strategy explained later in this section, that part of the profit will be taxed (through 2012) at no more than 15 percent (the maximum federal rate on long-term capital gains). If the client expects to reap another $500,000 of profit from development and marketing activities, that part will be taxed at ordinary income rates of up to 35 percent (through 2012). With this bifurcated tax treatment, the total tax hit is $325,000 ([15 percent × $1 million] + [35 percent × $500,000]). Without any planning, the entire $1.5 million profit would probably be taxed at 35 percent, which would create a $525,000 hit to the client's wallet.

With the preceding background in mind, the following sections will describe how to plan for and pay a much smaller tax bill on real estate development profits.

Step 1: Establish S Corporation to Be the Developer Entity

If the client individually owns the appreciated land all by himself or herself, the client can establish a new S corporation owned solely by him or her to function as the developer. If the client owns the land via a partnership (or via an LLC treated as a partnership for federal tax purposes), the client and the other partners (LLC members) can form the S corporation and receive corporate stock in proportion to their percentage partnership (LLC) interests.

[44] See IRC sec. 1221(a)(1) and *Winthrop v. U.S.* 69-2 USTC 9686 (5th Cir 1969).

Step 2: Sell the Land to the S Corporation

Next, the appreciated land is sold to the S corporation for a price equal to the land's pre-development fair market value. If necessary, the client can arrange a sale that involves only a little cash and a big installment note owed by the S corporation to the client. The S corporation will pay off the note with cash generated by selling off parcels after development. As long as the client has (1) held the land for investment and (2) owned the land for more than one year, the sale to the S corporation will trigger a long-term capital gain eligible for the 15 percent maximum federal rate (through 2012). Sweet!

Step 3: Develop the Property and Sell It Off

After buying the land, the S corporation will subdivide and develop the property, market it, and sell it off. All the profit from these activities will be ordinary income passed through to the client as an S corporation shareholder. If the profit from development and marketing is big, the client will probably pay the maximum 35 percent federal rate (though 2012). However, the average tax rate on the total profit will be much lower than 35 percent, because a big part of that total profit was pre-development appreciation taxed at the ultra-low 15 percent rate.

> **Key Point:** Thanks to the bifurcated tax treatment created by the S corporation developer entity strategy, your client can lock in the low long-term capital gains tax rate for all of the land's pre-development appreciation. That is a huge tax-saving advantage if the land has gone up hugely in value.

Make Sure the Developer Entity Is an S Corporation

To avoid adverse tax results, the developer entity must be an S corporation. Do not use a controlled partnership or a controlled LLC treated as a partnership for tax purposes. The reason for this advice is to avoid the little-known tax rule that mandates ordinary income treatment for gain from selling to a controlled partnership, when the property being sold is *not* a capital asset in the partnership's hands.[45] In your client's situation, the land will not be a capital asset in the hands of the developer entity. (As explained earlier in this chapter, the land will be "inventory.") Therefore, your client would have to treat any gain from selling the land to a controlled partnership as ordinary income (that is, a 35 percent tax rate), which would defeat the purpose of this strategy. Fortunately, there is no such rule for sales to controlled S corporations. (Clients should not use a C corporation in this situation, because they do not want double taxation of the profits from the developer entity's development and marketing activities.)

[45] IRC sec. 707(b)(2).

Anticipate IRS Challenges and Take Steps to Avoid Them

If your client plays his or her cards right, the S corporation developer entity strategy is not a risky scheme that will trigger problems with the IRS. Even so, advisers should anticipate potential IRS objections and plan ahead to counter them.

For instance, the IRS could claim the sale of the appreciated land to the S corporation was actually a contribution of capital to the corporation followed by corporate development and sales activities. If the IRS succeeds with this argument, all the profit from the whole venture would be considered high-taxed ordinary income generated by the S corporation and passed through to the client. Clients would not get the tax-saving bifurcated treatment they want. Under this IRS argument, the contribution of the land would be a tax-free IRC Section 351 transaction. Therefore, the S corporation's tax basis in the land would be the same as the land's basis in the hands of the contributing shareholder, under IRC Section 362. Because the corporation would be a real estate dealer, all the profit—including the part from the pre-development appreciation in the value of the land—would be triggered "inside" the corporation and then passed through as ordinary income to the shareholder. However, in *Bradshaw,* the taxpayer beat the IRS on this issue.[46] Despite this taxpayer victory, it is smart to head off any potential IRS challenge on this issue by taking the following steps:

1. Carefully document and execute the sale of the appreciated land to the S corporation.
2. If the client takes back an installment note from the S corporation, be sure the company pays the interest and principal on time and in accordance with the terms set forth in the note.
3. Keep the formation and capitalization of the S corporation and the sale of the land completely separate (preferably at least a few weeks apart in time). In other words, do not let the S corporation issue stock to the client at the same time he or she sells the appreciated land to the company.
4. Get a professional appraisal for the land before selling it to the S corporation. Charge the appraised price.

Alternatively, the IRS could argue that the S corporation is acting as the client's agent (as opposed to acting as a separate taxpayer) in the whole development process. If this argument is successful, the purported sale of the land to the S corporation would be completely disregarded. The client would be considered to still own the land and would fall into real estate dealer status. Therefore, the entire profit from the whole venture would have to be reported as high-taxed ordinary income on your client's Form 1040. However, in *Bramblett*, the court rejected this agency argument, despite some facts that were unflattering to the taxpayer.[47] The message from *Bramblett* is to keep the client's personal financial and legal affairs completely separate from the developer S corporation's affairs. That should defeat any agency argument without having to litigate the matter with the IRS.

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[46] See *Bradshaw, Jolana S.*, 82-2 USTC 9454 (Court of Claims 1982).

[47] See *Bramblett, Richard H.*, 92-1 USTC 50252 (5th Cir 1992).

Escaping Gains Altogether With a Like-Kind Exchange

Clients who are serious real estate investors periodically adjust their portfolios by getting rid of some properties and acquiring new ones. Unfortunately, selling appreciated properties results in a current tax hit, which is something real estate investors hate, especially when they intend to simply "roll over" their sales proceeds by purchasing new properties.

The good news is IRC Section 1031 allows taxes to be deferred if a so-called like-kind exchange can be arranged. In fact deferral is mandatory, rather than elective, when IRC Section 1031 applies.

IRC Section 1031 states that taxable gains are deferred when buyers and sellers swap properties that are similar in nature, except to the extent cash or dissimilar property (*boot*) is received in the transaction. If a party to the transaction receives boot, gain is currently recognized in an amount equal to the lesser of the total gain or the boot's FMV.[48]

Even deferred like-kind exchanges can qualify for the gain deferral privilege.[49] This is very important, because it is usually difficult for a seller who wants to make a like-kind exchange to locate another party who has suitable replacement property and who also wants to make an exchange rather than a cash sale. Under the deferred exchange rules, the seller need not make a direct and immediate exchange of one property for another. The seller can, in effect, sell for cash and then locate the replacement property a little bit later, and the owner of the replacement property can actually sell for cash without spoiling the first party's ability to defer his or her taxable gain.

Like-Kind Exchange Basics

Under IRC Section 1031, mandatory nonrecognition of gains (and losses) applies when *like-kind* properties are exchanged in what would otherwise be a taxable sale transaction. To qualify, both the property given up by the seller and the property received must be investment property or business property in the seller's hands. Note that investment property can be swapped for other like-kind investment property or for like-kind business property and vice versa. From the perspective of either party to the exchange transaction, it does not matter whether or not the other party qualifies under IRC Section 1031.[50]

Like-kind means similar in general nature or character. The regulations give a liberal interpretation to this standard. For example, Treasury Regulation 1.1031(a)-1 states that improved real estate can be swapped for unimproved real estate, a strip shopping center can be traded for an apartment building, a marina can be swapped for a golf course, and so on. However, real property cannot be traded for personal property. Lastly, property held for personal use (such as a home or a boat), inventory, partnership interests, and investment securities do not qualify for IRC Section 1031 treatment. In fact, the vast majority of IRC Section 1031 exchanges involve only real estate.

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[48] IRC sec. 1031(b).

[49] IRC sec. 1031(a)(3).

[50] Rev. Rul. 75-292.

Realized Versus Recognized and Receipt of Boot

When two parties wish to make a IRC Section 1031 exchange of properties with differing FMVs, the party with the less valuable property must add *boot*, or additional consideration to equalize the values. Boot can actually be in the form of cash, dissimilar property, or a mixture of both.

In analyzing an IRC Section 1031 transaction, the first step is determining the amount of realized gain (or loss) for each party. Realized gain equals

1. FMV of property (including any non-cash boot) plus any cash boot received, minus
2. the tax basis of the property given up (including any non-cash boot), plus any cash boot given.

In contrast to the realized gain, the *recognized* gain is the amount that must be currently reported under the federal income tax rules (not to exceed the realized gain). As explained earlier in this chapter, a party to an IRC Section 1031 exchange generally has no recognized gain unless boot is received. If boot *is* received, the recognized gain is the lesser of the

1. realized gain or
2. FMV of the boot.

Example 1-21

Huck and Buck trade undeveloped agricultural acreage in a IRC Section 1031 like-kind exchange. Huck's land has FMV of $50,000 and tax basis of $30,000. Buck's land is worth only $43,000, and his basis is $8,000. To equalize the trade, Buck gives Huck $7,000 worth of manure.

Huck's realized gain is $20,000 ($43,000 + $7,000 – $30,000); however, he currently recognizes only $7,000 (lesser of the $20,000 realized gain or the $7,000 worth of boot received).

Buck's realized gain is $35,000 ($50,000 – $8,000 – $7,000), but he has no recognized gain on the land swap, because he receives no boot.

Any loss realized in an IRC Section 1031 exchange cannot be recognized currently. As shown in example 1-23, the realized loss becomes *built-in* to the basis of the like-kind property received. If a party to the exchange gives only cash boot plus like-kind property and receives only like-kind property in return, he or she will not have any recognized gain.

However, if the transferor gives *dissimilar property* as boot, he or she recognizes gain or loss equal to the difference between its FMV and tax basis, as if it were sold for FMV.[51] For instance, if in example 1-21 Buck's basis in the manure was $4,000, he would recognize no gain on the land swap, but he would recognize a $3,000 gain on the manure part of the deal.

[51] Treas. Reg. 1.1031(d)-1(e).

Basis and Holding Period for Like-Kind Property Received

In effect, the tax basis of the like-kind property received is adjusted down or up for any unrecognized gain or loss attributable to the like-kind property given up.[52] Therefore, the tax basis of the like-kind property received equals

1. the tax basis of the like-kind property given up.
+ 2. gain recognized (if any) on like-kind property given up.
+ 3. FMV of boot given up (if any).
– 4. FMV of boot received (if any).

The holding period for the *new* like-kind property received includes the holding period of the *old* like-kind property given up.[53]

As for any noncash boot received, its tax basis will always be equal to FMV, because it is received in a fully taxable transaction. Therefore, as of the transaction date, a new holding period begins for the noncash boot.

Example 1-22

Use the same facts as in example 1-21. Huck's basis in the like-kind property received is $30,000 ($30,000 + $7,000 + 0 – $7,000). This makes sense because the property Huck now holds has a FMV of $43,000. In effect, the $13,000 unrecognized gain from the old property has become a $13,000 *built-in* gain in the new property (FMV of $43,000 less tax basis of $30,000).

Buck's basis in his new like-kind property is $15,000 ($8,000 + 0 + $7,000 – 0). Again, this makes sense because the property Buck now holds has a FMV of $50,000. Buck's $35,000 unrecognized gain from the old property has become a $35,000 built-in gain in the new property (FMV of $50,000 less tax basis of $15,000).

Example 1-23

Use the same facts as in example 1-21, except now Buck's basis in his original piece of land was $45,000.

His basis in the new like-kind property becomes $52,000 ($45,000 + 0 + $7,000 – 0). This makes sense, because the $2,000 unrecognized loss from the original land has become a $2,000 *built-in* loss in the land Buck now holds ($50,000 FMV less $52,000 tax basis).

Effect of Liabilities

In real life, most IRC Section 1031 real estate transactions involve properties burdened by mortgages. The impact of liabilities on realized and recognized gains and losses is explained subsequently.

Effect on Realized Gain Computation

Under Treasury Regulation 1.1031(d)-2, the transferor's realized gain equals

[52] IRC sec. 1031(d).

[53] IRC sec. 1223(1).

1. gross amount of debt shifted to the transferee.
2. + 2. FMV of boot received in form of cash, dissimilar property (if any), or both.
3. + 3. FMV of like-kind property received.
4. – 4. tax basis of like-kind property given plus any boot given.
5. – 5. gross amount of liabilities taken on by transferor.

Effect on Recognized Gain Computation

The transferor's recognized gain equals the lesser of the realized gain (discussed previously) or the boot received. When the transferee assumes a liability or takes property subject to a liability, this counts as boot received for purposes of computing the recognized gain. When both parties assume liabilities or take property subject to liabilities, amounts are netted. For example, if the transferor takes on liabilities in excess of the amount shifted to the transferee, the transferor has *given* boot equal to the net amount, and the transferee has *received* boot in the same amount.

However, deemed net boot given from liabilities (excess of the line 5 amount over the line 1 amount) cannot be used to offset *actual* boot received in the form of cash, dissimilar property, or both (the line 2 amount).[54] Put another way, the transferor must recognize gain equal to the lesser of the realized gain or the actual boot received (the line 2 amount), even when the transferor has given net boot attributable to liabilities.

When the transferor gives actual boot in the form of cash or dissimilar property (included in the line 4 amount), the actual boot given offsets any net boot received from liabilities (excess of line 1 amount over line 5 amount).[55] Thus, if actual boot given exceeds the net boot received from liabilities transferred to the other party, there is no recognized gain.

Example 1-24

Rhonda owns Happy Acres (FMV of $4,000,000, mortgage of $3,400,000, and tax basis of $3,000,000). She swaps the property for Grumpy Hills (FMV of $3,600,000, mortgage of $3,500,000, and tax basis of $3,200,000), which is owned by Bill. Because Bill's equity in Grumpy Hills is only $100,000 versus Rhonda's $600,000 equity in Happy Acres, Bill tosses in $500,000 of cash to square the deal.

Rhonda's realized gain is

1.	$3,400,000	Happy Acres debt shifted to Bill
2.	500,000	FMV of boot received
3.	3,600,000	FMV of like-kind property received
4.	(3,000,000)	Tax basis of property given up
5.	(3,500,000)	Grumpy Hills debt assumed by Rhonda
	$1,000,000	

Rhonda's recognized gain is limited to $500,000, which equals the amount of actual boot received. Rhonda gets no "credit" for the $100,000 of net boot given from liabilities (excess of $3.5 million she assumed over

[54] Treas. Reg. 1.1031(d)-2, example 2.

[55] Treas. Reg. 1.1031(d)-(2), example 2.

$3.4 million she shifted to Bill). However, as will be seen subsequently, the net boot given from liabilities increases Rhonda's tax basis in Grumpy Hills.

Rhonda's tax basis in Grumpy Hills is

1. $3,000,000 ____________ Tax basis of Happy Acres
2. 100,000 ____________ Boot given from liabilities
3. 500,000 ____________ Gain recognized on disposition of Happy Acres
4. (500,000) ____________ Boot received (cash)

$3,100,000

Thus, Rhonda has a *built-in* gain of $500,000 in Grumpy Hills (FMV of $3,600,000 less her basis of $3,100,000). This equals her realized gain of $1,000,000, less the $500,000 deferred by making the like-kind exchange.

1. $3,500,000 ____________ Grumpy Hills debt shifted to Rhonda
2. 0 ____________ FMV of boot received
3. 4,000,000 ____________ FMV of like-kind property received
4. (3,700,000) ____________ Tax basis of property and boot given
5. (3,400,000) ____________ Happy Acres debt assumed by Bill

$400,000

Bill's recognized gain is $0, because he offsets the $100,000 of net boot received from liabilities with the $500,000 of actual boot given to Rhonda.

Bill's basis in Happy Acres is

$3,200,000 ____________ Tax basis of Grumpy Hills

500,000 ____________ Boot given

0 ____________ Gain recognized on disposition of Grumpy Hills

(100,000) ____________ Boot received (from liabilities)

$3,600,000

Thus, Bill has a *built-in* gain of $400,000 in Happy Acres (FMV of $4,000,000 less his basis of $3,600,000). This equals his realized gain of $400,000 from Grumpy Hills, all of which was deferred by making the like-kind exchange.

Deferred Like-Kind Exchanges

Although the tax advantages of making a like-kind exchange are considerable for both parties, it is usually difficult or impossible to locate another party who has suitable like-kind property and is willing swap (most sellers want cash or at least an installment sale arrangement). As a result, IRC Section 1031 exchanges are rarely accomplished by making a simultaneous exchange of like-kind properties; rather, *deferred exchanges* (commonly called *Starker* exchanges, after a famous 1979 court case) are used. The qualification rules for deferred exchanges are found in Treasury Regulation 1.1031(k)-1. Deferred exchanges come in two flavors: three-party deals and four-party deals.

Deferred Three-Party Exchanges

In this type of transaction, the transferor (the *first* party) trades his or her property to the *second* party, who then promises to find and buy replacement property from a *third* party.

The second party places the sales proceeds that would otherwise go to the first party in escrow. The funds are then used by the second party to purchase replacement property from a third party.

Finally, the replacement property is transferred by the second party to the first party. This completes the like-kind exchange.

Because the first party never actually gets his or her hands on any cash and ends up with like-kind property, the transaction is considered an IRC Section 1031 exchange from his or her perspective.

Deferred Four-Party Exchanges

When the second party cannot or will not acquire replacement property to swap with the first party—or cannot be trusted to do so—a four-party exchange is required. This type of exchange is more common than the three-party variety described in the previous section.

In a deferred four-party exchange, the transferor (the *first* party) transfers his or property to a qualified intermediary (the *fourth* party).

The intermediary's role is simply to facilitate a like-kind exchange for a fee.

The first party's property is transferred to a cash buyer (the *second* party).

The intermediary then uses the resulting sales proceeds to buy suitable replacement property (which has been previously identified by the first party) from a *third* party.

Finally, the intermediary transfers the replacement property to the first party to complete the like-kind exchange.

From the first party's perspective, this whole series of transactions qualifies as a like-kind exchange because he or she ends up with like-kind replacement property (supplied by the third party) rather than cash. The second party ends up paying cash for the original property (supplied by the first party). The third party ends up having sold his property for cash (supplied by the second party).

Naturally, qualified intermediaries charge for their services, usually based on a sliding scale according to the value of the deal. In percentage terms, the fees are generally quite nominal.

Tax Rules for Deferred Exchanges

IRC Section 1031(a)(3) and Treasury Regulation 1.1031(k)-1 supply the two basic rules for deferred exchanges:

1. Replacement property must be identified before the end of a 45-day *identification period*.
2. Replacement property must be transferred to the seller before the end of the *exchange period*, which can extend up to 180 days.

The identification period commences when the first party transfers the original property (in other words, the closing date for that transaction). During the 45-day period, the

replacement property must be unambiguously identified or actually received by the first party. This rule is satisfied if the replacement property is specified in a written document signed by the first party and sent to (1) the party who is to supply the replacement property or (2) another party, such as a qualified intermediary, escrow agent, or title company. In the document, the first party can list up to 3 properties considered suitable as replacement property. However, the aggregate FMV of the 3 cannot exceed 200 percent of the FMV of the original property.

The exchange period also commences when the first party transfers the original property. The exchange period ends on the *earlier* of (1) 180 days thereafter or (2) the due date (with extensions) of the first party's federal return for the tax year that includes the date of transfer. When the 180-day period straddles year-ends and would be cut short by the original due date of the return for the year of the transfer, obtaining an extension restores the full 180-day period. However, an extension must actually be obtained in order for this provision to come into play.

Avoiding Constructive Receipt Problems With Escrow Arrangements

When the first party transfers property in exchange for the buyer's promise to purchase and transfer suitable replacement property (or the qualified intermediary's promise), the first party will naturally want assurance that the remaining legs of the transaction will be accomplished. Therefore, the buyer's promise to acquire and transfer replacement property is generally secured by placing the sales price in an escrow account. Alternatively, the funds may be placed in escrow with the qualified intermediary hired to facilitate the exchange.

The potential problem with escrow accounts is that the IRS may claim the first party was in constructive receipt of the sales proceeds. This would unravel the intended like-kind exchange and result in a taxable sale transaction. However, Treasury Regulation 1.1031(k)-1(g) provides safe harbor rules for escrow accounts. If these are met, constructive receipt problems are avoided.

Under the safe harbor rules, the first party will not have constructive receipt of cash or cash equivalents placed in a *qualified escrow account* if

- the escrow holder is not a *disqualified person* (various parties related to the first party and parties considered agents of the first party) and
- the escrow agreement expressly limits the first party's right to receive, borrow, pledge, or otherwise obtain the benefits of the assets held in the escrow account.

Despite the latter rule, the first party is *not* prohibited from being credited with interest on funds held in a qualified escrow account.[56]

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[56] Treas. Reg. 1.1031(k)-1(g)(5), (g)(6), and (h).

Example 1-25

Melinda (the first party) owns Halfacre, which is worth $2,000,000 and has a tax basis of $500,000. Second-party Harold (unrelated to Melinda) wants to buy the parcel for development. However, Melinda insists on a like-kind exchange in order to avoid any current tax liability.

Ultimately Melinda agrees to transfer Halfacre in exchange for Harold's promise to acquire and transfer suitable replacement property. In accordance with the agreement, Melinda transfers Halfacre to Harold on December 1, 2011. Harold's promise is secured by $2,000,000 of cash placed in a qualified escrow account.

Within the 45-day identification period, Melinda sends Harold a signed document designating Pineland—currently owned by Vanessa (the third party) and having a FMV of $1,600,000—as suitable replacement property.

On March 19, 2012, Harold buys Pineland from Vanessa for $1,600,000 cash. On the same day, he transfers Pineland to Melinda along with the $400,000 balance from the escrow account.

In this example, both the 45-day identification period rule and 180-day exchange period rule are met (the starting point for both periods is the December 1, 2011, the closing date for the transfer of Halfacre to Harold). Accordingly, this deal qualifies as a deferred three-party exchange for Melinda. On March 19, 2012, she recognizes a $400,000 taxable gain—lesser of $400,000 boot received or realized gain of $1.5 million.[57]

Note: The escrow arrangement must be a *qualified escrow account*, in order to avoid any risk of Melinda being considered in constructive receipt of the entire $2,000,000 as of December 1, 2011.

Four-Party Exchanges With Qualified Intermediaries

Second parties are often unwilling or unable to acquire title to the replacement property or are not considered trustworthy enough to be relied upon. In such cases, the solution is using a qualified intermediary to conduct a four-party exchange.

Under the IRC Section 1031 regulations, the qualified intermediary is *not* considered the agent of the first party, even though the intermediary actually functions in that capacity. Accordingly, the first party can transfer his or her property to the qualified intermediary and instruct the intermediary to sell the property for cash. The first party will not be considered in constructive receipt of the sales proceeds received by the qualified intermediary.[58] (If the intermediary does not meet the qualified-intermediary definition, there will generally be an agency relationship for tax purposes, and the first party will have a constructive receipt problem.)

Treasury Regulation 1.1031(k)-1(g)(4) defines a *qualified intermediary* as a person who is not the taxpayer or a *disqualified person* and who, pursuant to a written *exchange agreement* with the taxpayer,

- acquires the original property from the taxpayer,
- transfers the taxpayer's property to the buyer,
- acquires replacement property from the seller, and
- transfers the replacement property to the taxpayer.

[57] See Treas. Reg. 1.1031(k)-1(g)(8), example 1, and Treas. Reg. 1.1031(k)-1(j)(2)(vi), example 1.

[58] Treas. Reg. 1.1031(b)-2(a).

Disqualified persons are defined in Treasury Regulation 1.1031(k)-1(k) and include certain parties automatically considered to be the taxpayer's agent (taxpayer's employee, attorney, and so on) and certain parties related to the taxpayer under IRC Sections 267(b) or 707(b), as modified.

In real estate transactions, qualified intermediaries may be unwilling to actually hold title to the original and replacement properties—however briefly—because of environmental liability issues. Therefore, Treasury Regulation 1.1031(k)-1(g)(4)(v) states that the qualified intermediary is deemed to accomplish the previously mentioned title transfers via written assignments of contract rights. Actual title transfers are not necessary. Example 1-26 illustrates the rules that must be satisfied to accomplish a successful deferred four-party exchange.

Example 1-26

Use the same facts as in example 1-25, except, for the reason discussed in the previous section, Harold refuses to have even momentary ownership of Pineland because of potential exposure to environmental liabilities for any owner in the chain of title. Therefore, Melinda engages a qualified intermediary—We Do Swaps—to facilitate a deferred four-party exchange.

On December 1, 2011, Melinda contracts to sell Halfacre to Harold for $2 million cash. The closing date is to be January 15, 2012. On or before that date, Melinda enters into a written exchange agreement with We Do Swaps to function as a qualified intermediary. (We Do Swaps is also unwilling to hold actual title to the properties involved in the transaction.)

Before title to Halfacre is actually transferred to Harold, Melinda assigns in writing to We Do Swaps her contract rights to sell the property (this is pursuant to the exchange agreement between Melinda and We Do Swaps). Melinda also notifies Harold of the assignment in writing before transferring Halfacre to him. Melinda then transfers title to Halfacre directly to Harold on January 15, 2012. This is called a *direct deed* transaction, because the title to Halfacre actually bypasses We Do Swaps. At closing, Harold transfers $2,000,000 to a qualified escrow account set up at the local bank (or the payment could go into an account controlled by We Do Swaps).

Melinda now locates Pineland (owned by Vanessa) and contracts to purchase it as replacement property for $1,600,000. The scheduled closing date for this transaction is March 19, 2012. Before that date, Melinda assigns in writing to We Do Swaps her contract rights to buy Pineland and notifies Vanessa of this assignment in writing. On March 19, 2012, the escrow agent releases $1,600,000 to Vanessa to close on Pineland. On the same date, Vanessa direct-deeds Pineland to Melinda. Melinda also receives the remaining $400,000 from the escrow account.

All legs of the deferred exchange are now complete. The 45-day and the 180-day rule are both met (the starting point for both periods is the January 15, 2012 closing date for the Halfacre transaction). By entering into the exchange agreement with We Do Swaps and assigning her purchase and sale contract rights, Melinda is deemed to have made a like-kind exchange with We Do Swaps. As a qualified intermediary, We Do Swaps is deemed to have acquired and transferred both Halfacre and Pineland.

Accordingly, on March 19, 2012, Melinda recognizes a $400,000 taxable gain. Note that these are exactly the same tax results as in example 1-25, which involved a three-party exchange.[59]

[59] See Treas. Reg. 1.1031(k)-1(g)(8), example 4, and Treas. Reg. 1.1031(k)-1(j)(2)(vi), example 2.

Variation

The tax results would also be the same if pursuant to the exchange agreement with Melinda, We Do Swaps takes actual title to Halfacre and Pineland before transferring them to Harold and Melinda, respectively.[60]

Warning: If Melinda fails to transfer her Halfacre contract rights to We Do Swaps on or before direct deeding Halfacre to Harold, she is not considered to have engaged in a like-kind exchange with We Do Swaps. The unfortunate result is that Melinda is now treated as having made a taxable sale of Halfacre to Harold, followed by a taxable purchase of Pineland through her agent, We Do Swaps.[61]

"Reverse-Starker Exchanges" Are Now Clearly Allowed

As explained earlier in this chapter, deferred exchanges in which the replacement property is identified and acquired after the "relinquished property" (the property originally held by the taxpayer seeking IRC Section 1031 exchange treatment) has effectively been sold are often called *Starker* exchanges. As discussed, regulations permit properly structured *Starker* exchanges to fall under the IRC Section 1031 rules which can yield tremendous tax deferral advantages for real estate clients.

However, the tax treatment of so-called reverse *Starker* exchanges has been left unclear for many years. In a reverse-*Starker* exchange, the replacement property is acquired *before* the relinquished property is unloaded. In other words, the taxpayer has identified a property he or she wishes to acquire in an IRC Section 1031 exchange but has not yet identified the property he or she will give up in exchange. The regulations cited earlier in this chapter do not provide any guidance regarding such reverse *Starker* exchanges.

In Revenue Procedure 2000-37 (as modified by Revenue Procedure 2004-51), the IRS finally addressed this longstanding question. Revenue Procedure 2000-37 provides safe-harbor treatment (meaning IRC Section 1031 treatment will be deemed to apply) for reverse *Starker* exchanges that are conducted via qualified exchange accommodation arrangements (QEAAs).

A QEAA is considered to exist if the following conditions are met:

1. To facilitate the exchange, the legal titles to (or attributes of beneficial ownership in) both the replacement and relinquished properties are transferred to an *exchange accommodation titleholder* (as defined by Revenue Procedure 2000-37). Once the exchange accommodation titleholder acquires title to (or attributes of beneficial ownership in) the replacement and relinquished properties, the exchange accommodation titleholder must continue to hold the properties until the replacement property is ultimately transferred to the taxpayer and the relinquished property is ultimately transferred to its new owner.
2. At the times the replacement property and the relinquished property are transferred to the exchange accommodation titleholder, the taxpayer (the party seeking IRC Section 1031 treatment for the deal) must have a bona fide intent to exchange said properties

[60] See Treas. Reg. 1.1031(k)-1(g)(8), example 3.
[61] See Treas. Reg. 1.1031(k)-1(g)(8), example 5.

in a transaction that qualifies for nonrecognition treatment (in whole or in part) under IRC Section 1031.

3. Within 5 business days after the date of transfer of title to (or attributes of beneficial ownership in) the replacement or relinquished property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder must agree in writing that said property is being held to facilitate a IRC Section 1031 exchange under Revenue Procedure 2000-37 and that the tax reporting rules established by Revenue Procedure 2000-37 will be respected by both parties.
4. Within 45 days after the transfer of title to (or attributes of beneficial ownership in) the replacement property to the exchange accommodation titleholder, the taxpayer must identify the relinquished property in a manner consistent with Treasury Regulation 1.1031(k)-1(c). (Alternative or multiple properties may be identified.)
5. Within 180 days after the transfer of title to (or attributes of beneficial ownership in) the replacement property or relinquished property to the exchange accommodation titleholder, the replacement and relinquished properties must be transferred to their respective new owners.
6. The combined time period that the replacement and relinquished properties are held by the exchange accommodation titleholder cannot exceed 180 days.

The exchange accommodation titleholder fulfills the same role as a qualified intermediary in a "regular" four-party deferred exchange, as explained in example 1-26. The taxpayer should take pains to ensure that the exchange accommodation titleholder does in fact meet the definition of a qualified intermediary.

In essence, the exchange accommodation titleholder is simply a transient owner (or beneficial owner) of the relinquished property and the replacement property. However, the exchange accommodation titleholder is treated for tax purposes as the legitimate legal owner solely in order for IRC Section 1031 treatment to apply to the exchange.

The taxpayer and the exchange accommodation titleholder can engage in certain commercially necessary transactions in order to effect the desired property exchange. For example, the taxpayer can loan the exchange accommodation titleholder the money needed to acquire the replacement property or the taxpayer can guarantee debt incurred by the exchange accommodation titleholder to do so. The taxpayer can also indemnify the exchange accommodation titleholder against costs incurred in the transaction. The taxpayer can even lease the replacement property from the exchange accommodation titleholder, and the taxpayer can manage the replacement property and supervise improvements to it while it is held by the exchange accommodation titleholder.[62]

However, the IRS admits that some reverse-*Starker* exchanges that fall outside Revenue Procedure 2000-37 guidelines may still qualify for IRC Section 1031 treatment, presumably based on consideration of all facts and circumstances.[63] In other words, the rules under Revenue Procedure 2000-37 are only intended as a safe harbor for reverse *Starker* exchanges,

[62] See sec. 4.03 of Rev. Proc. 2000-37.

[63] See sec. 3.02 and sec. 3.04 of Rev. Proc. 2000-37.

as opposed to absolute standards that must be followed in order for IRC Section 1031 treatment to apply. For example, the IRS has allowed IRC Section 1031 treatment for a direct reverse *Starker* exchange.[64] On the other hand, the IRS has disallowed IRC Section 1031 treatment for other reverse *Starker* exchanges for various reasons.[65]

> **Observation:** As a practical matter, taxpayers seeking IRC Section 1031 treatment for reverse *Starker* exchanges would be crazy not to comply with the safe harbor guidelines of Revenue Procedure 2000-37 (as modified by Revenue Procedure 2004-51).

Example 1-27

Use the same facts as in Example 1-26, except this time Melinda identifies the replacement property before she identifies the property she wishes to relinquish in a reverse *Starker* exchange. Melinda engages a qualified intermediary—We Do Swaps—to function as the exchange accommodation titleholder in what ultimately turns out to be a four-party reverse *Starker* exchange with Vanessa and Harold.

On December 1, 2011, Melinda contracts with Vanessa to purchase Pineland as the replacement property for $1,600,000. The scheduled closing date for this transaction is January 15, 2012. Before that date, Melinda assigns in writing to We Do Swaps her contract rights to buy Pineland. This is pursuant to the exchange agreement between Melinda and We Do Swaps. Melinda also notifies Vanessa of this assignment in writing. Melinda then loans We Do Swaps the $1,600,000 needed to buy Pineland. We Do Swaps is unwilling to hold actual legal title to the properties involved in the exchange for liability reasons. Melinda, Vanessa, and We Do Swaps agree in writing that Pineland will be beneficially owned (albeit only momentarily) by We Do Swaps to facilitate an IRC Section 1031 exchange under the Revenue Procedure 2000-37 guidelines. At the closing on January 15, 2012, Vanessa direct deeds Pineland to Melinda (that is, the actual legal title to Pineland bypasses We Do Swaps and goes directly to Melinda), and We Do Swaps releases the $1,600,000 to Vanessa.

On January 20, 2012, Melinda finally identifies Halfacre as the property she wishes to relinquish in exchange for Pineland. On that same date, she contracts to sell Halfacre to Harold for $2 million cash. The closing date is March 19, 2012. On or before that date, Melinda enters into a written exchange agreement with We Do Swaps to function as a qualified intermediary.

Melinda assigns in writing to We Do Swaps her contract rights to sell Halfacre to Harold. Melinda also notifies Harold of the assignment in writing. Melinda, Harold, and We Do Swaps agree in writing that Halfacre will be beneficially owned (albeit only momentarily) by We Do Swaps to facilitate an IRC Section 1031 exchange under the Revenue Procedure 2000-37 guidelines. At the closing on March 19, 2012, Melinda direct deeds Halfacre to Harold; he transfers $2,000,000 to We Do Swaps; and We Do Swaps transfers the $2,000,000 to Melinda. The $2,000,000 represents a return of the $1,600,000 loan from Melinda to We Do Swaps plus the $400,000 difference between the sale price for Halfacre ($2,000,000) and the purchase price for Pineland ($1,600,000).

All legs of the reverse *Starker* exchange are now complete. The 45-day and the 180-day rule are both met (the starting point for both periods is the January 15, 2012, the closing date for the Pineland transaction). By entering into the exchange agreement with We Do Swaps and assigning her purchase and sale contract rights, Melinda is deemed to have made a like-kind exchange with We Do Swaps. (For this purpose, the transactions with Vanessa and Harold are ignored.)

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[64] See Ltr. Rul. 9823045.

[65] See TAM 200039005 and *Donald DeCleene, et ux. v. Commissioner*, 115 TC No. 34 (November 17, 2000).

Accordingly, on March 19, 2012, Melinda recognizes a $400,000 taxable gain. This is the amount of taxable cash boot that she received when all was said and done. Note that these are exactly the same tax results as in example 1-26, which involved a "regular" *Starker* exchange.

Variation

The tax results would be the same if pursuant to the exchange agreement with Melinda; We Do Swaps takes actual legal title to Pineland and Halfacre before transferring them to Melinda and Harold, respectively.[66]

Warning: If Melinda fails to transfer her Halfacre contract rights to We Do Swaps on or before direct deeding Halfacre to Harold, she is not considered to have engaged in a like-kind exchange with We Do Swaps. The unfortunate result is that Melinda is now treated as having made a taxable purchase of Pineland through her agent, We Do Swaps, followed by a taxable sale of Halfacre to Harold.[67]

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[66] See Treas. Reg. 1.1031(k)-1(g)(8), example 3.

[67] See Treas. Reg. 1.1031(k)-1(g)(8), example 5.

2

Planning for Employer Stock and Stock Options

Introduction

With preferential tax rates on long-term capital gains, tax-smart strategies are important for employer stock and employer stock options. This chapter covers several easy to implement tax-saving ideas, starting with options strategies.

Employer Stock Options

Clients who work for a company that grants employee stock options are well positioned to benefit from both the appreciation potential and lower capital gain rates.

Shares acquired via options will eventually be sold, hopefully for a healthy profit. The general tax planning objectives are to

- have most or all of that profit taxed at low capital gain rates and
- put off paying any taxes for as long as possible.

The two basic varieties of employee stock options are as follows:

1. Incentive stock options (ISOs) (sometimes called qualified options or statutory options) are defined by Internal Revenue Code (IRC) Section 422 and are entitled to preferential tax treatment. ISOs, however, are also subject to some special restrictions and unfavorable handling under the alternative minimum tax (AMT) system.
2. Nonqualified stock options (NQSOs) are not subject to such restrictions, but they also confer no special tax breaks on their owners beyond deferring income recognition.

Buying and Selling ISO Shares

An option must meet certain rules (set forth in IRC Section 422 and related regulations) upon issuance to qualify as an ISO. The single most important rule is the requirement that the exercise price cannot be below the stock's market value at the time the employee receives the option.

For regular tax purposes, ISOs deliver two major league advantages (the not-so-favorable AMT situation is explained later in this chapter):

1. When the option is exercised, the excess of market value over exercise price (that is, the bargain *element*) goes untaxed at that time.
2. When ISO shares are sold, the entire profit (that is, excess of sale price over exercise price) can qualify for the 15 percent long-term capital gain rate (through 2012). However, to qualify for that rate the date of sale must be

   a. more than 2 years after the option grant date (that is, when the employee was given the option) and
   b. more than 12 months after the shares are purchased (that is, by exercising the option).

If the two holding-period rules are satisfied, the employee can achieve the twin goals of having the entire profit taxed at the lowest possible rate and delaying the tax bill until shares are sold and the employee has the cash to pay the tax.

Example 2-1

On March 1, 2010, Elvette was granted an ISO allowing her to buy 200 shares of company stock at $25. On October 1, 2010, she exercised when the stock was trading at $34. On May 1, 2012, the shares were trading at a lofty $52, and she cashed in her chips.

Elvette met the ISO requirements because the sale date was more than two years after the March 1, 2010, grant date and more than 12 months after the October 1, 2010, exercise date. Her entire $5,400 profit ($27 per share) counts as a 2012 long-term capital gain eligible for the 15 percent rate.

As always with stock, the insatiable appetite for tax savings must be balanced against the risk of a price decline if the shares are held long enough to qualify for the 15 percent rate.

What if Elvette's luck was not so good and she sold her company shares for less than their value on the exercise date ($34), or, even worse, below her exercise price ($25)?

Elvette's per-share tax basis equals the exercise price. Therefore, if she sells for more than $25, she still would have a capital gain taxed at a maximum of 15 percent. If her sale price is below $25, she has a capital loss.

AMT Rules for ISO Shares

Unfortunately, the bargain element on the exercise date counts as a *positive adjustment* for AMT purposes (positive for the Treasury, negative for the employee) in the year of exercise.[1] The adjustment increases AMT income, which may cause the AMT to exceed the regular tax bill. If so, the taxpayer must pay the higher amount. (If not, the adjustment does no harm.)

If the taxpayer does end up owing AMT, he or she may be entitled to an AMT credit, which can be used to reduce the regular tax bill in a later year. Use Form 6251 (Alternative Minimum Tax—Individuals) to see if the taxpayer owes AMT in the year of exercise. If so,

1 Internal Revenue Code (IRC) sec. 56(b)(3).

Form 8801 (Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts) should be completed when preparing the following year's return to see if there is a credit.

In some cases, *staggering* the exercise of ISOs can avoid triggering the AMT with a large bargain element number in a single year. Unfortunately, this does not work too well when a stock continues to rise. As it goes up, the bargain element on the remaining unexercised ISO shares gets bigger, which can defeat the staggering strategy.

However, staggering can make sense near year-end. For example, a taxpayer can exercise some ISOs in December of the current year and the rest early in the following year. Assuming the stock does not rise much between the two exercise dates, this could avoid AMT in both years.

Another strategy is to simply exercise the ISOs before the stock price advances much beyond the exercise price. Then the bargain element is minimal, and the AMT bill may fade into oblivion. Of course, to use this *exercise early* technique, the taxpayer must come up with the money to pull the trigger, so he or she should be confident the stock will rise enough to justify the investment.

When ISO shares are sold, the gain or loss must be calculated under the AMT rules. The AMT basis equals the market price on the exercise date (not the lower exercise price, which is the regular tax basis). The higher AMT basis shows up as a *negative adjustment* on Form 6251 in the year of sale. So if the taxpayer sells for more than the market price on the exercise date, there is a gain for both AMT and regular tax, but the AMT number will be lower. If the sale price is less than market price on the exercise date but more than the exercise price, there is an AMT loss and a regular-tax gain. In either case, if the AMT credit was earned in the year of exercise and has not yet been used, the taxpayer can likely use the credit in the year of sale.

Example 2-2

Use the same basic facts as in example 2-1, except that now Elvette would have done her 2010 AMT bookkeeping by entering a $1,800 positive adjustment (the $9 per share bargain element) on Form 6251. Her per-share AMT basis becomes $34 (market value at exercise).

In preparing her 2011 return, she completed Form 8801 and found that she ran up an AMT credit from the 2010 exercise. If she owed regular tax in 2011, she can use the credit to reduce her regular tax, at least to the point at which it equals her 2011 AMT number.

On Elvette's 2012 Form 6251, she will report an $1,800 negative adjustment when she sells her shares for $52 each, so her AMT gain will be only $3,600, compared to $5,400 for regular-tax purposes.

If Elvette has any leftover AMT credit, she can probably use it to reduce her 2012 regular tax bill.

Disqualifying Dispositions of ISO Stock

If a taxpayer sells ISO shares within two years of the grant date or one year of the exercise date, it is too soon according to the tax law. The seller has made a *disqualifying disposition*. This will not get the taxpayer into any trouble with the government, but it will hike his or her tax bill. Nevertheless, it is sometimes smart to make a disqualifying disposition, for a reason explained later in this section.

When the sale price exceeds the exercise price, there is of course a regular-tax gain. Gain up to the amount of the bargain element (that is, spread between market value and exercise price on the exercise date) is considered compensation income in the year of sale, so that piece gets taxed at regular rates (up to 35 percent through 2012). However, no employment taxes are due, and no income tax withholding is necessary. Any additional profit is capital gain.

The tax rate on the *capital gain piece* depends on how long the shares were owned (ownership starts on the exercise date). For example, if there is a disqualifying disposition because the sale date is less than 2 years after the grant date but the sale date is more than a year after the exercise date, the capital gain piece is taxed at no more than 15 percent (through 2012).

Obviously, disqualifying dispositions have the negative effect of causing all or part of the profit to be taxed at rates above 15 percent (through 2012). But the key word here is *profit*. If the stock is diving, holding on too long may simply erase the taxpayer's gain. Until the federal tax rate reaches 100 percent, people are better off taking the gain early with a disqualifying disposition and paying Uncle Sam a bit more.

If someone is unlucky (or stubborn) enough to hold onto ISO shares until they fall below the exercise price, there is a regular-tax capital loss on a disqualifying disposition.

AMT Rules

Now consider the AMT rules for disqualifying dispositions. If the exercise and disqualifying disposition occur in the same year, there is no AMT impact. However, if exercise and disqualifying disposition occur in two different years, the positive adjustment for the bargain element may cause an AMT liability in the exercise year, as explained earlier in this chapter. That will ideally generate an AMT credit which can be used in the year of sale, when the seller is entitled to a negative adjustment for the basis difference.

Notice that all the AMT damage (if any) is over and done with in the year the ISO is exercised. After that, taxpayers should just pay attention to the regular tax consequences of either hanging onto the ISO shares long enough to have the entire profit taxed at 15 percent (through 2012) or prudently bailing out early with a disqualifying disposition.

Liberalized AMT Credit Rules for 2008–12 Will Help Those Who Exercised Lucrative ISOs in Prior Years

For tax years beginning in 2008–12, the Emergency Economic Stabilization Act of 2008 provided greatly liberalized refundable AMT credit rules. Under the refundable AMT credit deal, an individual taxpayer with a *long-term unused AMT credit* amount (meaning the amount of unused AMT credits that were generated in years before the 3 immediately preceding years) is guaranteed to be able to collect at least 50 percent of that long-term amount in the form of a refundable AMT credit. The refundable credit amount is allowed to offset the taxpayer's regular federal income tax liability, as well as any AMT liability. Any refundable credit amount remaining after the federal income tax bill has been reduced to 0 is paid to

the taxpayer in cash.[2] Therefore, the revamped refundable AMT credit rules are great news for individuals who have big unused AMT credits. Some people have them in amounts that run into 6 figures and more. Now they will finally be able to collect them, although it may take a few more years for this to happen.

> **Key Point:** For 2011, the long-term unused AMT credit amount equals the amount of any leftover credits generated in pre-2008 years. To take advantage of these credits, the taxpayer must file Form 8801 with his or her Form 1040 (U.S. Individual Income Tax Return) and report the refundable credit amount on the appropriate line(s) on page 2 of Form 1040. For 2012, the long-term unused AMT credit amount equals the amount of leftover credits generated in pre-2009 years. To cash in, the taxpayer must file Form 8801 with his or her 2012 Form 1040 and report the refundable credit amount on the appropriate line(s).

Refundable AMT Credit Annual Limitation Rule for 2008–12

The amount of refundable AMT credit for the current year is subject to an annual limitation. Under the limitation, the refundable amount equals the *greater* of

1. 50 percent of the long-term unused AMT credit amount carried into the current year (which equals the amount of unused credits that were generated more than 3 years before the current year) or
2. the amount of refundable AMT credit that was calculated for the preceding year.

However, the refundable AMT credit amount for the current year cannot exceed the long-term unused AMT credit carried into that year.[3]

Example 2-2A

Miranda carries a $190,000 AMT credit into her 2010 tax year. Of that amount, $140,000 was generated in 2006 when she exercised some profitable ISOs. The remaining $50,000 was generated in 2007 when Miranda exercised some more ISOs.

For 2010, Miranda's long-term unused AMT credit amount is $140,000 (the amount of unused credit generated in pre-2007 years). Under the annual limitation rule, Miranda's refundable AMT credit amount is $70,000 (0.50 × $140,000). She can collect the entire $75,000 by filing her 2010 Form 1040 with Form 8801 attached. "Collect," in this case means that Miranda can use the $70,000 to reduce her 2010 federal income tax bill (including any AMT) to 0 with any leftover refundable credit amount either sent to her in cash or applied to her 2011 estimated federal income tax payment obligation.

For 2011, Miranda's long-term unused AMT credit amount is $120,000 (consisting of the $70,000 left over from 2010 plus the $50,000 generated in 2007 that becomes long-term in 2011). Under the annual limitation rule, Miranda's 2011 refundable AMT credit amount is $70,000 (greater of [*a*] 50 percent of the $120,000 long-term unused AMT credit amount carried into 2011 or [*b*] the $70,000 refundable credit calculated for 2010).

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[2] See IRC sec. 53(e).

[3] See IRC sec. 53(e)(2).

For 2012, Miranda's long-term unused AMT credit amount is the $50,000 left over from 2011. Under the annual limitation rule, Miranda's 2012 refundable AMT credit amount is $50,000 (greater of [*a*] 50 percent of the $50,000 long-term carryover into 2012 or [*b*] the $70,000 refundable credit calculated for 2011, limited to the $50,000 amount carried into 2012).

Key Point: In this particular case, the AMT credit generated in 2006 was collected over 2 years once it became a long-term credit (50 percent in 2010 and the remaining 50 percent in 2011). The entire credit generated in 2007 was collected in 2012 (the second year after it became a long-term credit). As you can see, the refundable AMT credit rules guarantee that it takes no more than 2 years to collect a credit once it becomes a long-term credit.

Use First-In-First-Out to Determine Unused AMT Credits from Prior Tax Year

To determine the amount of unused AMT credits left over from a prior tax year (if any), use the first-in-first out (FIFO) method.[4]

Example 2-2B

In 2005, Orlando generated a $25,000 AMT credit, and he generated another $30,000 credit in 2008, for a total of $55,000 carried into his 2010 tax year (no credits were generated in any other pre-2010 years). In 2010, Orlando utilized $28,000 worth of AMT credit (he did not generate any credit in that year). Under the FIFO rule, the entire $27,000 unused AMT credit carried into 2011 ($55,000 – $28,000) is deemed to come from 2008. Because Orlando has no long-term unused AMT credit for 2011 (the credit generated in 2008 is not yet more than 3 years old), he is ineligible for the refundable AMT credit deal in 2011. However in 2012, any unused credit from 2008 will become a long-term credit that is eligible for the refundable credit deal.

Coordination of Regular and Refundable AMT Credit Rules

A taxpayer's refundable AMT credit amount for the year is the minimum amount of AMT credit he or she can collect for that year. If the regular AMT credit rules result in a larger credit amount, that larger amount can be collected. When some AMT credit is allowed under the regular rules, but a larger amount is allowed under the refundable rules, the taxpayer can collect the larger amount. But the refundable amount is then reduced by the regular amount. These points are illustrated by the following examples.

Example 2-2C

For 2011, Nancy has a $45,000 long-term unused AMT credit carryover from pre-2008 years. Under the refundable AMT credit rules, she is guaranteed to be able to collect $22,500 of AMT credit (0.50 × $45,000) after filing her 2011 Form 1040. However, Nancy's 2011 regular federal income tax liability is $50,000, and her 2011 AMT liability is only $26,000. In this case, the $24,000 AMT credit amount allowed under the regular rules ($50,000 – $26,000) exceeds the $22,500 refundable AMT credit amount. Therefore, Nancy simply utilizes $24,000 of credit under the regular rules to reduce her 2011 regular tax liability to the point at which it equals her AMT liability.[5] The remaining $21,000 of credit ($45,000 – $24,000) is carried into to

[4] See IRC sec. 53(e)(3)(B).

[5] See IRC sec. 53(c).

2012. Due to the way the refundable AMT credit annual limitation rule works, Nancy is guaranteed to be able to collect the entire $21,000 when she files her 2012 return.

Key Point: If you follow the Form 8801 instructions, you will discover that credits allowed under the regular rules and refundable credits are reported on two different lines on page 2 of Nancy's Form 1040.

Example 2-2D

Use the same basic facts as in example 2-2C, except that now Nancy's regular tax federal income liability for 2011 is only $32,000. She can collect $6,000 of AMT credit in 2011 under the regular rules ($32,000 – $26,000) and she can collect $16,500 in 2011 under the refundable rules ($22,500 – $6,000) for a total of $22,500 in 2011. If you follow the Form 8801 instructions, you will discover that the $6,000 credit allowed under the regular rules and the $16,500 refundable credit are reported on two different lines on page 2 of Nancy's 2011 Form 1040.

Nonqualified Stock Options

As mentioned earlier in this chapter, employer stock options that do not qualify as ISOs are NQSOs. This discussion does not cover special rules that apply to *restricted stock* acquired with NQSOs. (An example of restricted stock is the situation in which ownership of the shares vests over a period of time provided the employee is still working for the company. The rules under IRC Section 83 apply to restricted stock.)

The tax rules for NQSOs are less favorable than for ISOs, but NQSOs have one huge advantage. They can be issued with an exercise price below the stock's current market value. Because they can be delivered with a nice *built-in gain*, NQSOs are what corporate bigwigs typically get. (However, whenever an option exercise price is set below a stock's current market value at the date of the option's issuance, evaluate any impact of IRC Section 409A, which could potentially be triggered, resulting in an acceleration of the recognition of deferred income along with related imputed interest income and penalties.)

When an NQSO is exercised, the bargain element (difference between market value and exercise price at the time of exercise) is generally taxed at ordinary-income rates in that year's tax return. (In unusual cases when NQSOs are publicly traded, tax may accrue on the grant date.)

Basis in the shares equals market price on the exercise date. Any subsequent appreciation is capital gain taxed when the shares are sold, and that amount is eligible for the 15 percent rate (through 2012) if the shares are held more than 12 months. If the stock goes down and is sold for less than the market price on the exercise date, there is a capital loss. This is simple enough, and you will be pleased to know there are no special AMT rules for NQSOs.

Example 2-3

Use the same basic facts as in example 2-1, except that now Elvette's option is a NQSO issued when the price of the stock was $29. As before, the exercise price is $25, and Elvette exercised when the market price was $34. Because the option is an NQSO, Elvette paid 2010 tax on the $1,800 bargain element at her ordinary rate ($540 at a 30 percent marginal rate). Her per-share basis is $34, and her holding period began on October 2, 2010.

When she sells on May 1, 2012, for $52 per share, Elvette has a $3,600 long-term capital gain taxed at the optimal 15 percent rate. When all is said and done, she netted an after-tax profit of $4,320 ($1,800 + $3,600 – $540 – $540).

That is not bad, but if Elvette could have exercised earlier when the stock was worth less than $34, she could have cut her tax bill for the year of exercise and increased the gain taxed later at only 15 percent. In fact, this is now the "conventional wisdom" for NQSOs: exercise early to minimize the current tax hit and maximize the amount treated as long-term capital gain when the option shares are sold.

Hold That Option, Version 1

This section provides another option strategy worth considering for both ISOs and NQSOs: instead of spending cash to exercise the option, a taxpayer can use the same amount to buy shares of company stock at market. The taxpayer can then hold those shares until he or she has a significant gain eligible for the 15 percent rate (or whatever the preferential rate for long-term capital gains happens to be at the time). The shares can then be sold and the 15 percent (or whatever) tax paid, with the after-tax proceeds then used to exercise the option. The taxpayer can then immediately sell the NQSO shares. This sale results in tax at the ordinary rate on the entire profit from the option shares, but the taxpayer can still come out ahead because there are 2 gains instead of 1.

Example 2-4

Use the same basic facts as in example 2-1, except that now Elvette buys 147 shares at $34 with the same $5,000 needed to exercise her ISO for 200 shares at $25. She could then sell the 147 shares at $52 to net $7,249 after paying 15 percent tax on the $2,646 gain. She then spends $5,000 to exercise her option on the 200 shares and immediately sells the option shares for $10,400.

Because this is a disqualifying disposition, Elvette owes tax at her regular rate of 28 percent on the $5,400 profit, so she pays another $1,512 to Uncle and collects an after-tax profit of $3,888 ($5,400 – $1,512). However, Elvette's after-tax profit from the two sales is $6,137 ($2,249 + $3,888) versus only $4,320 on the same $5,000 investment that would have been needed just to exercise the ISO.

Hold That Option, Version 2

Although the preceding strategy of holding the option and investing the exercise price in additional company shares is fine, taxpayers may be well advised to instead hold the option and spend the same amount on other attractive equity investments. This results in a more diversified portfolio and avoids the risk that the employer stock may not perform as well as other equity alternatives.

Eventually, the taxpayer can sell the other equities, pay the 15 percent tax (or whatever the preferential long-term capital gains rate happens to be at the time) and use the money to exercise the company stock option before it expires. Then, the taxpayer can turn around and sell the company shares immediately if he or she wishes. Again, this strategy can be pursued with both NQSOs (see example 2-5) and ISOs (see example 2-6).

Example 2-5

Oswald has an NQSO to buy 500 company shares at $25 (the stock is currently worth $30). Instead of spending $12,500 to exercise immediately, he invests the same amount in several other stocks in different industries.

Four years later, it is time to exercise the option because it is about to expire. Oswald's company stock and the other equities have all appreciated 10 percent annually. So he sells the other shares and pays 15 percent on the $5,801 gain to net $4,931 (0.85 × $5,801). He then takes $12,500 and exercises the option on the 500 company shares, which are now worth $21,962. Oswald sells those immediately and pays 35 percent (his marginal rate) on the entire $9,462 profit, resulting in an after-tax take of $6,150 (0.65 × $9,462). So Oswald netted $11,081 ($4,931 + $6,150) from the 2 deals even after cutting in the government for its exorbitant share.

If he had simply exercised his option when the stock was at $30, Oswald would have paid Uncle Sam $875 in Year 1 (35 percent of the $2,500 spread) plus another $1,044 when he sold [0.15 × ($21,962 – $15,000)]. His after-tax take would be only $7,543 ($21,962 – $12,500 – $875 – $1,044), compared to the $11,081 from holding the option and investing the exercise price. (Oswald comes out even better if his marginal tax rate is lower than the anticipated 35 percent.)

Example 2-6

Use the same basic facts as in example 2-5, except that now Oswald's option is an ISO to buy 500 company shares at $30 (the current market price). Instead of spending $15,000 to exercise the ISO, Oswald again invests the exercise price in several other stocks in different industries.

Four years later, it is time to exercise the option. The company stock and the other equities have all appreciated 10 percent annually, so Oswald sells the other shares and pays his 15 percent on the $6,962 gain to net $5,918 (0.85 × $6,962). He then takes $15,000 and exercises the option on the 500 company shares, which are now worth $21,962. If he sells those immediately and pays 35 percent on the entire $6,962 profit, his after-tax take is still $4,525. So Oswald bags $10,443 from the 2 deals on an after-tax basis ($5,918 + $4,525).

If he had simply exercised his ISO when the stock was at $30, Oswald would owe $1,044 when he sold [0.15 × ($21,962 – $15,000)], and his after-tax take would be only $5,918 ($6,962 – $1,044).

Federal Payroll Tax Implications of Employer Options

Nonqualified Options

When an employee exercises an NQSO, the bargain element (difference between exercise price and fair market value [FMV] on the date of exercise) is treated as ordinary income from compensation. The income is therefore subject to federal income tax withholding and the Social Security, Medicare, and Federal Unemployment Tax Act (FUTA) taxes[6] and should be reported on the employee's Form W-2.[7] From the employee's perspective, the

[6] See Rev. Ruls. 67-257 and 79-305.

[7] Treas. Reg. 1.83-6(a).

federal employment tax hit is only 1.45 percent (from the Medicare tax) if his or her 2012 compensation exceeds $110,100 before considering the income from exercising the NQSO. However, this additional tax cost should be considered in analyzing NQSO strategies.

Incentive Stock Options

For many years, it was clear that no Social Security or Medicare taxes (collectively referred to as federal employment taxes for purposes of this chapter) were triggered by *exercising* an ISO. This only made sense, because under IRC Section 421(a), exercising an ISO is *not* a taxable event for regular federal income tax purposes, even when there is a positive "spread" between the exercise price and the market value of the underlying shares on the date of exercise. (However, the "spread" *is* considered income for AMT purposes per IRC Section 56[b][3].)

Similarly, it was clear that no federal employment or FUTA taxes were triggered by a *disqualifying disposition* of employer shares acquired by exercising an ISO. Nor was any federal income tax withholding required. This was the case even though part or all of the taxable income triggered by a disqualifying disposition income can be treated as compensation income taxed at ordinary rates.

These taxpayer-friendly rules were originally courtesy of Revenue Ruling 71-52. In IRS Notice 87-49, the government announced it would continue its favorable policy regarding federal employment taxes on disqualifying dispositions of ISOs. IRS Notice 87-49 also announced that Revenue Ruling 71-52 was under reconsideration, and that guidance could eventually change. Thankfully, however, the status quo will continue to prevail for the foreseeable future.

Per IRS Notice 2002-47, the IRS will *not* assess federal employment or FUTA taxes on (1) the "spread" from exercising ISOs or (2) taxable income triggered by disqualifying dispositions of shares acquired by exercising ISOs. Furthermore, the IRS will *not* impose federal income tax withholding on (1) the exercise of ISOs or (2) taxable income triggered by disqualifying dispositions of shares acquired by exercising ISOs.

Thankfully, the American Jobs Creation Act of 2004 made this favorable treatment statutory and eliminated any further uncertainty on the subject.

Year-End Sale of ISO Shares Can Avoid AMT Hit

If your client exercised some ISOs earlier in the current year, he or she may be facing a big AMT hit. This is because the *bargain element* (the difference between market value and exercise price on the exercise date) is a positive AMT adjustment in the year of exercise. So far, so bad. But it can get worse—much worse.

If the client's ISO shares have now plummeted in value below the exercise price (not unusual these days), does his or her current-year AMT liability go away? Unfortunately, it will not—unless he or she takes action before the end of the year of exercise.

If the client does nothing, he or she will still owe the AMT on value that has now evaporated when filing his or her Form 1040 for the year of exercise. Is this fair? No! But life isn't always fair, especially with taxes. So what can your client do?

Well, he or she can solve the AMT problem by selling his or her low-performing ISO shares before year-end. As you know, this is a disqualifying disposition, which sounds bad. But in your client's situation, it may be the best thing to do. When the client makes a disqualifying disposition in the same year the ISO is exercised, the AMT adjustment disappears; that is the AMT hit disappears. Now your client simply has a garden-variety short-term capital loss on the sale of his or her ISO shares. For both regular tax and AMT purposes, that loss equals the difference between the net sale price and the exercise price.

If the client has capital gains from other current-year transactions, he or she can use his or her capital loss to offset his or her gains. That will reduce his current-year tax bill further.

If the client already has an overall current-year capital loss, he or she just adds the loss from his or her disqualifying disposition to the total. The client can then deduct a maximum of $3,000 of capital losses against his or her taxable income from all other sources ($1,500 if married and filing separately). Of course, if his or her current-year capital loss exceeds the $3,000 (or $1,500) limit, the excess is carried over to next year. That is still a whole lot better than paying an unfair AMT bill for the current year.

But Watch Out for This!

If your client wants to buy back company shares after selling his or her ISO shares in a disqualifying disposition, he or she should wait at least 31 days to do so. This advice applies whether the client will incur a loss from the disqualifying disposition, or break even on the deal, or even generate a taxable gain.

A little-known provision in the regulations dealing with ISO shares states that the tax results are *truly horrific* to the extent employer shares are reacquired within 30 days of a disqualifying disposition. According to the rule, the disqualifying disposition triggers ordinary income (for both regular tax and AMT purposes) equal to the full amount of the bargain element that existed at the time of exercise. That income is then added to the taxpayer's basis in the ISO shares, which means the disqualifying disposition will now result in a large capital loss. Triggering ordinary income and an offsetting capital loss is bad enough. Even worse, the capital loss is then disallowed under the IRC Section 1091(a) wash sale rule.[8]

Employer Stock From Qualified Retirement Plan Distributions

In general, retiring employees are well advised to roll over their distributions from company qualified retirement plan accounts into individual retirement accounts (IRAs). This avoids an immediate tax hit and allows the taxpayer to continue to benefit from tax-deferred earnings until withdrawals are actually needed to finance living costs.

[8] See Treas. Reg. 1.422-1(b)(2)(ii) and (b)(3), example 3.

Withdraw Shares and Hold in Taxable Account

However, when a qualified retirement plan account holds appreciated employer stock, the taxpayer may be better off withdrawing the shares and holding them in a taxable account rather than rolling the shares over into an IRA.

As long as the shares are part of what qualifies as a lump-sum distribution from the taxpayer's qualified plan accounts, only the amount of the plan's cost basis for the shares (generally the FMV of the shares when they were acquired by the plan) is taxed currently.[9] (Everything else received in the lump-sum distribution can, and generally should, be rolled over into the IRA.)

If the shares have appreciated substantially over the years, the cost basis could be a relatively small percentage of the shares' value on the distribution date (remember, however, that the cost basis number will not necessarily be an insignificant amount).

If the taxpayer is under age 59½, the 10 percent *premature distribution* penalty tax will also apply, but it will apply only to the cost basis amount rather than to the full FMV of the stock.[10]

Offsetting Benefits

The tax on the cost basis is at the taxpayer's ordinary rate, but the following are the offsetting benefits:

- The net unrealized appreciation when the shares are distributed (the difference between FMV on the distribution date and the plan's cost basis for the shares) qualifies for the 15 percent maximum long-term capital gain rate through 2012 (or 0 percent for gains that would otherwise fall in the 10 percent or 15 percent bracket through 2012).[11]
- The capital gain tax on that unrealized appreciation is deferred until the shares are sold.
- Any postdistribution appreciation (after the shares come out of the qualified plan account) also qualifies for the 15 percent (or 0 percent) rate if the shares are sold through 2012 more than 12 months after the taxpayer's holding period begins.[12] For this purpose, the taxpayer's holding period commences on the day after the shares are delivered by the plan to the transfer agent with instructions to reissue the shares in the employee's name.[13]
- If the taxpayer dies while still owning the shares, the heirs get a basis step-up for the postdistribution appreciation.[14] However, the heirs will owe tax on the unrealized appreciation amount at 15 percent (or 0 percent) for sales through 2012 under the *income in respect of a decedent* rule.[15]

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9 IRC sec. 402(e)(4)(B).
10 IRC sec. 72(t)(1).
11 See IRS Notice 98-24.
12 Treas. Reg. 1.402(a)-1(b)(1)(i).
13 Rev. Rul. 82-75.
14 IRC sec. 1014(a) and (c).
15 Rev. Rul. 75-125.

Rollover Into IRA

In contrast, if the shares are rolled over into an IRA, there is no tax until money is withdrawn from the account. However, all the unrealized appreciation and all the postdistribution appreciation will wind up being taxed at ordinary rates. In addition, if the shares are still in the IRA at death, the taxpayer's heirs will owe tax at ordinary rates on their withdrawals from the IRA, including amounts attributable to unrealized appreciation and postdistribution appreciation.

Example 2-7

Bruce retires from a large corporation at age 62. As part of a lump-sum distribution from several retirement plan accounts, he receives 1,000 shares of employer stock with a cost basis to the plan of $10,000. The current FMV of the shares is $40,000, and Bruce expects the stock to continue to appreciate.

Instead of rolling the shares into an IRA, Bruce heeds the advice of his CPA and holds the stock in a taxable account. (He rolls over everything else.) He pays tax at his ordinary rate of 25 percent on the $10,000 cost basis. Years later, Bruce passes on, and his shares have appreciated to a value of $100,000.

Bruce's heirs receive a basis step-up equal to the postdistribution appreciation ($60,000 in this case assuming the current basis step-up rule continues). When they sell the stock, they will owe capital gain tax (at rate of 20 percent in this example) on the unrealized appreciation (the $30,000 difference between the plan's $10,000 cost basis in the shares and the $40,000 FMV as of the distribution date) plus any appreciation that occurs after Bruce's death up to the date of sale.

If there is no further appreciation and the 20 percent rate applies, the total tax paid on the $100,000 worth of stock will be only $8,500 ($2,500 by Bruce in the year of the distribution plus $6,000 [20 percent of the $30,000 unrealized appreciation] by the heirs when the stock is sold).

In contrast, if Bruce had rolled the shares into an IRA, his heirs would owe tax at their ordinary rates on the entire $100,000 when the IRA is liquidated. In all likelihood, their taxes would total at least $25,000.

Warning:

- The preceding tax treatment applies *only* to shares received as part of a lump-sum distribution.
- If the shares are distributed from a qualified retirement plan and are not part of a lump-sum distribution, the tax consequences of not rolling the shares over into an IRA are much less favorable.
- Specifically, the full FMV of the shares will be taxed as ordinary income, except to the extent of any nondeductible employee contributions plus the unrealized appreciation attributable to such nondeductible contributions.[16]
- However, postdistribution appreciation will still qualify for preferential long-term capital gains rates if the shares are held more than 12 months before they are sold.

[16] IRC sec. 402(e)(4)(A).

3

All About Roth Individual Retirement Accounts

Introduction

For several reasons, Roth individual retirement accounts (IRAs) are a big deal right now. This chapter covers planning opportunities available with Roth IRAs as well as pitfalls to avoid.

Roth IRA Basics

Roth IRAs Have Two Big Tax Advantages

There are two big advantages of converting traditional IRAs (including SEP-IRAs and SIMPLE-IRAs) into Roth IRAs.

Big Advantage No. 1: Qualified Withdrawals Are Tax-Free

Unlike traditional IRA withdrawals, qualified Roth IRA withdrawals are federal-income-tax-free (and usually state-income-tax-free, too). In general, a *qualified withdrawal* is one that is taken after the Roth account owner has met *both* of the following requirements:

1. He or she has had at least one Roth IRA open for more than 5 years.
2. He or she has reached age 59½, or he or she is disabled, or he or she is dead.[1]

For purposes of meeting the five-year requirement, the clock starts ticking on the first day of the tax year for which the individual's initial contribution to any Roth account was made. That initial contribution can be a regular annual contribution, or it can be a conversion contribution.[2]

[1] See IRC sec. 408A(d)(2).

[2] See Treas. Reg. 1.408A-6, Q&A-2.

Example 3-1

Fern, your calendar-year client, opened up her first Roth IRA by making a regular annual contribution on April 15, 2008, for her 2007 tax year. The 5-year clock started ticking on January 1, 2007 (the first day of Fern's 2007 tax year), even though she did not actually make her initial Roth contribution until April 15, 2008.

Big Advantage No. 2: Exemption from Required Minimum Distribution Rules

Unlike with a traditional IRA, the original owner of a Roth account (that is, the person for whom the account was originally set up) is not burdened with the requirement to start taking required minimum distributions (RMDs) after age 70½. Therefore, an original account owner is free to leave his or her Roth account untouched for as long as he or she lives. This important privilege makes the Roth IRA a great asset to leave to one's heirs (to the extent the account owner does not need the Roth IRA money to help finance his or her own retirement).

After the original account owner's death, however, the Roth IRA's beneficiaries must follow the same set of RMD rules that apply to an inherited traditional IRA that was originally owned by a person who died before his or her RMD beginning date. The RMD beginning date is April 1 of the year following the year during which the account owner turns age 70½.[3] Fortunately, the RMD rules for inherited accounts can turn out to be quite favorable for a Roth IRA beneficiary, because the rules usually allow the beneficiary to take RMDs over his life expectancy. Therefore, an inherited Roth IRA can potentially continue to earn federal-income-tax-free profits for many years (depending on the beneficiary's age).

Considerations and Rules for Annual Roth Contributions

Good Idea for Clients Who Expect High Taxes during Retirement

The idea of making annual Roth IRA contributions makes the most sense for those who believe they will pay the same or higher tax rates during retirement. Higher future taxes can be avoided on Roth account earnings, because qualified Roth withdrawals are federal-income-tax-free (and usually state-income-tax-free too). The downside is that clients get no deductions for Roth contributions.

If your client expects to pay lower tax rates during retirement, he or she might be better off making deductible traditional IRA contributions (assuming his or her income so permits), because the current deductions may be worth more to him or her than tax-free withdrawals later on. The other best-case scenario for annual Roth contributions is when the client has maxed out his or her deductible retirement contribution possibilities (perhaps because his or her income is too high for deductible traditional IRA contributions).

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[3] See Treas. Reg. 1.408A-6, Q&A-14.

Contributions Are Limited and Earned Income Is Required

The absolute maximum amount an individual can contribute for any tax year to a Roth IRA is the lesser of (1) his or her earned income for that year or (2) the annual contribution limit for that year. Basically, *earned income* means wage and salary income (including bonuses), alimony received (believe it or not), and self-employment income.

For 2012, the annual Roth contribution limit is $5,000, or $6,000 if the account owner is age 50 or older as of year-end. This assumes the account owner is unaffected by the adjusted gross income (AGI)-based phase-out rule explained later in this chapter.

> **Key Point:** These annual Roth IRA contribution limitation rules are exactly the same as the rules for annual contributions to traditional IRAs.

> **Key Point:** The client must reduce his or her annual Roth contribution limit by any amounts contributed to traditional IRAs for the year. In other words, the $5,000 or $6,000 annual contribution limit for 2012 applies to the sum total of the account owner's contributions to Roth IRAs and any deductible or nondeductible contributions to traditional IRAs.

Client and Spouse Can Operate Independently

If your client is a married joint-filer, both she and her spouse can probably make annual Roth contributions to their separate accounts, assuming there are no problems with the earned income limitation explained previously or the modified adjusted gross income (MAGI)-based phase-out rule explained in the following section.

For purposes of the earned income limitation, the client can add his or her earned income to that of his or her spouse. If your client's joint earned income for 2012 is $100,000, but none of that is earned by the client's spouse, he or she will have no problem. For 2012, the client can make a $5,000 Roth contribution or $6,000 if he or she is age 50 or older and so can his or her spouse. This is allowed because the couple's combined earned income ($100,000) exceeds their combined Roth contributions ($12,000 at most).[4]

Annual Contribution Privilege Is Phased Out at Higher Incomes

For 2012, eligibility to make annual Roth contributions is phased out between MAGI of $110,000 and $125,000 for unmarried individuals. For married joint filers, the 2012 phase-out range is between joint MAGI of $173,000 and $183,000. For those who use married filing separate status, the 2012 phase-out range is between MAGI of $0 and $10,000. (Good luck with that!)

To calculate a client's MAGI, start with "regular" AGI from the last line on page 1 of his or her Form 1040 (U.S. Individual Income Tax Return). Then add back (1) any deduction for traditional IRA contributions, (2) any Internal Revenue Code (IRC) Section 222 deduction for higher-education tuition and fees, (3) any IRC Section 221 deduction for student loan interest, (4) any IRC Section 137 tax-free employer adoption assistance payments,

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[4] See IRC secs. 408(A)(c)(2) and 219(c)(1).

(5) any IRC Section 135 tax-free interest from U.S. Savings Bonds redeemed to pay higher-education costs, (6) any IRC Section 199 deduction for domestic production activities, and (7) any IRC Section 911 tax-free foreign earned income and housing allowances.[5] Note that add-backs 4–7 are not terribly common.

> **Key Point:** If your client's MAGI is too high for annual Roth contributions, he or she should consider converting a traditional IRA into a Roth account. For 2010 and beyond, there is no longer any income restriction on Roth conversions. Roth conversions are discussed later in this chapter.

Annual Contribution Deadline

The deadline for making annual Roth contributions is the same as the deadline for annual traditional IRA contributions, that is, the original due date of the return. For example, the contribution deadline for the 2012 tax year is April 15, 2013. However, your client can make a 2012 contribution anytime between now and then. The sooner the client contributes, the sooner he or she can start earning tax-free income.

Older Clients Can Still Make Annual Contributions

After reaching age 70½, your client can still make annual Roth IRA contributions, assuming there are no problems with the earned income limitation or the MAGI-based phase-out rule. In contrast, contributions to traditional IRAs are off limits for the year the client reaches age 70½ and for all future years.[6]

Participation in Retirement Plans Does Not Affect Eligibility for Annual Contributions

Eligibility to make annual Roth contributions is unaffected by your client's participation (or his or her spouse's participation) in a tax-favored retirement plan. In contrast, an MAGI phase-out rule restricts the client's right to make deductible traditional IRA contributions if either he or she or his or her spouse participates in a plan.[7]

No Tax Return Reporting Required for Annual Contributions

There is nothing to report on your client's Form 1040 when he or she makes an annual Roth contribution. However, please keep track of the contributions. If he or she ever needs to take nonqualified withdrawals in the future, he or she can withdraw up to the total amount of his or her annual contributions without any tax or penalty.

> **Key Point:** Nonqualified Roth IRA withdrawals generally must be reported on Part III of Form 8606 (Nondeductible IRAs).

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[5] See IRC secs. 408A(c)(3)(B) and 219(g)(3).

[6] See IRC secs. 408A(c)(4) and 219(d)(1).

[7] See IRC sec. 219(g).

Help Clients Take Advantage of Wide-Open Roth IRA Conversion Opportunity

Whole New Ballgame for Conversions

The two big Roth IRA tax advantages explained earlier in this chapter are not new. They have been around for years. However, the following considerations *are* new (or relatively new) in the context of Roth conversions.

Higher Future Tax Rates Are a Distinct Possibility

The possibility that income tax rates (both federal and state) will be hiked sharply for upper-income individuals is a new development. As mentioned at the beginning of this chapter, higher rates are scheduled for 2013 and beyond. Therefore, other things being equal, the tax cost of a 2012 Roth conversion may be a whole lot less than the tax cost of a conversion in 2013 and beyond.

Restrictions on Roth Conversions Are Gone

For pre-2010 years, an income restriction made individuals with MAGI higher than $100,000 ineligible for Roth conversions. For 2010 and beyond, that MAGI restriction is completely off the books. Now, even billionaires are eligible for Roth conversions.

The fact that any and all of your upper-income clients can now make Roth conversions is a big development, because conversion contributions are the only way to quickly get large amounts of money into a Roth IRA. On a less-important note, the pre-2010 restriction that made individuals who use married filing separate status ineligible for Roth conversions is also off the books for 2010 and beyond.[8]

> **Key Point:** Clients can now convert traditional IRAs into Roth accounts no matter how high their incomes and no matter what filing status they use.

Traditional IRA Balances May Still Be Depressed

A third important new (or semi-new) consideration is that many people still have traditional IRAs that are worth significantly less than before the 2008–9 stock market meltdown. Other things being equal, the tax cost of converting a traditional IRA with a still-depressed balance is lower than the tax cost of converting one with a higher balance.

> **Key Point:** The tax cost of converting now may turn out to be historically low, due to the combined effects of still-low federal income tax rates and still-depressed traditional IRA balances.

[8] See IRC sec. 408A(b)(3).

Taxable Income from 2010 Conversions Can Be Deferred and Spread Over Two Years

A Roth conversion is treated as a distribution from the traditional IRA followed by a nondeductible contribution to the Roth IRA. The deemed distribution from the traditional IRA will almost always trigger a current federal income tax hit (and often a state income tax hit too). As explained later in this section, the client must aggregate all his or her traditional IRAs, including any SEP-IRAs and SIMPLE-IRAS, to determine how the deemed distribution from a Roth conversion will be taxed.

For 2010 only, for federal income tax purposes, the taxable income triggered by a 2010 Roth conversion can be deferred and spread evenly over 2011 and 2012 (50 percent in each year). In fact, this defer-and-spread treatment is automatic unless the taxpayer makes an election on Form 8606 to instead report 100 percent of the conversion income in 2010.[9]

Depending on your client's tax rates in those years, the defer-and-spread deal may or may not be a good deal. If it is not a good deal, the client can elect to report all the taxable income triggered by a 2010 conversion on his or her 2010 Form 1040. The deadline for electing out of the defer-and-spread deal was October 18, 2011, if the client extended his or her 2010 Form 1040 to that date. By then, the client would have known significantly more about what his or her tax situation was for 2011 and 2012.

> **Key Point:** The defer-and-spread deal was only allowed for 2010 conversions. It will not be available for conversions in later years unless Congress decides to extend it, which seems unlikely.

> **Key Point:** The choice to go with (1) the defer-and-spread option for a 2010 conversion or (2) the alternative option of electing to report all income from a 2010 conversion in that year applies to all 2010 conversions. In other words, a client who converts several accounts in 2010 apparently cannot pick and choose between the two options. Instead, the same option must be followed for all 2010 conversions.[10]

High-Income Clients Can Circumvent MAGI Restriction on Annual Roth Contributions

Before 2010, high-income clients who did not have any traditional IRAs to convert but loved the idea of Roth IRAs were out of luck because their high income prevented them from making annual Roth contributions. Thanks to the removal of the MAGI-based restriction on Roth conversions for 2010 and beyond, high-income clients can finally get into the Roth IRA game. A client can first make an annual nondeductible contribution to a new traditional IRA (there is no income restriction on such contributions). Then, he or she should immediately convert the new nondeductible traditional IRA balance into Roth status.

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[9] See IRC sec. 408A(d)(3)(A)(iii).

[10] See IRC sec. 408A(d)(3)(A)(iii) and IRS Publication 590, *Individual Retirement Arrangements*, and the instructions to Form 8606 (Nondeductible IRAs).

Because the new nondeductible traditional IRA's tax basis equals the amount that was just contributed to that account, the conversion of the account balance to Roth status is a totally tax-free maneuver. In this indirect fashion, the client can make annual Roth IRA contributions of up to $5,000, or up $6,000 if he or she is age 50 or older, even though he or she has a high income. The only catch is that the client must have earned income each year that at least equals his or her nondeductible traditional IRA contribution for that year. If the client is married, he or she can count his or her spouse's earned income for this purpose.[11]

> **Warning:** If the client has one or more *existing* traditional IRAs, converting the new nondeductible traditional IRA into Roth status will generally *not* be a tax-free maneuver, which may any douse enthusiasm for the whole idea. See the discussion later in this chapter of how nondeductible contributions affect conversions under the account aggregation rule.

Is This the Perfect Storm for Roth Conversions?

For all the preceding reasons, 2012 may be the perfect storm for Roth conversions. The chance to convert (without any income restriction) traditional IRA balances into federal-income-tax-free Roth IRA balances at a historically low current tax cost might prove irresistible to many well-off individuals. Also, there will be plenty of time to evaluate the wisdom of any 2012 conversions, because they can be reversed as late as October 15, 2013. The reversal privilege is explained later in this chapter.

Roth Conversion Basics

Partial Conversions Are Allowed

Clients who have several traditional IRAs can choose to convert some accounts and leave the rest alone. Similarly, they can choose to convert only a proportion of the balances in one or more traditional IRAs and left the rest of their balances in traditional IRA status.

Client and Spouse Can Operate Independently

When a client is married and the client and his or her spouse each have traditional IRAs, the client and spouse can consider the Roth conversion opportunity independently for their respective traditional IRAs. What one spouse does (or does not do) has no effect on the other spouse—other than affect joint AGI and joint taxable income that results from making a conversion (or not).

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[11] See IRC secs. 408(A)(c)(2) and 219(c)(1).

Impact of Nondeductible Contributions under Account Aggregation Rule

A client can have several traditional IRAs and make nondeductible contributions over the years to one or more of these accounts. When he or she chooses to convert some but not all of his traditional IRA balances to Roth status, the nondeductible contributions will generally make the deemed distribution from the conversion partially taxable and partially tax-free. The calculation of the taxable and tax-free amounts is based on the aggregate balance of all of the client's traditional IRAs (including any SEP-IRAs or SIMPLE IRAs) on the conversion date and the aggregate amount of all nondeductible contributions to those accounts.[12] This account aggregation rule means the taxable and tax-free percentages of the deemed distribution from a conversion will be the same, regardless of which traditional IRA is actually converted. (Accounts owned by the client's spouse have no impact on the client's account aggregation calculations.)

Example 3-2

Hank owns two traditional IRAs: IRA-1 and IRA-2. Each account is worth $40,000. The entire $40,000 balance in IRA-1 is from deductible contributions and earnings. In contrast, the $40,000 balance in IRA-2 is from $20,000 of nondeductible contributions and $20,000 of deductible contributions and earnings.

Hank converts IRA-2 into a Roth account. The resulting $40,000 deemed distribution will be 25 percent tax-free ($20,000/$80,000) and 75 percent taxable ($60,000/$80,000). Therefore, Hank will have a $30,000 taxable distribution ($40,000 × 0.75) to report on his Form 1040. If Hank expected the deemed distribution to be 50 percent tax-free (because half of the IRA-2 balance was from nondeductible contributions), he will be disappointed.

Key Point: Pursuant to the account aggregation rule, converting IRA-1 would also result in a $30,000 taxable distribution.

Variation

In the rare circumstance when the aggregate value of Hank's traditional IRAs on the conversion date is equal to or less than the aggregate amount of his nondeductible contributions to the accounts, the conversion of one or both accounts would not trigger any taxable income. In such case, there does not appear to be any downside to converting both accounts into Roth IRA.

How to Make a Conversion

There are three basic ways to accomplish a conversion by moving funds from a traditional IRA into a Roth IRA:

1. The client can simply *recharacterize* (a weird word chosen by the IRS that means the same thing as *convert*) the entire existing traditional IRA into a new Roth account managed by the same IRA trustee or custodian. This action can be taken for some or all of the client's traditional IRAs. All that is required to effect a conversion in this manner is filling out a form and submitting it to the trustee or custodian. With such an "in-house" conversion, there is no need to liquidate the converted account's assets. Any stocks,

[12] See IRC sec. 408(d)(2).

mutual funds, and so on are transferred automatically from the old traditional IRA into the new Roth IRA.

2. If the client wants to switch his or her IRA trustee or custodian as part of the conversion process (for example, by converting an existing traditional IRA held at a bank into a new Roth IRA), the initial step is to make a direct trustee-to-trustee transfer of the traditional IRA's assets from the bank to a new traditional IRA. This step is tax-free, and it keeps the account's assets intact. Then the client can make an "in-house" conversion of the traditional IRA into a Roth IRA. This last step of the process is a taxable event.
3. Another way to effect a conversion is to withdraw some or all of the funds from one or more traditional IRAs and then roll the funds over by contributing them to one or more new or existing Roth accounts under the familiar 60-day rollover rule.

All three of the procedures are referred to as *conversions* in this chapter.

> **Recommendation:** Other things being equal, it is prudent to keep Roth conversions simple by (1) converting the entire balance of a traditional IRA rather than just a portion and (2) setting up a new Roth IRA to receive each significant Roth conversion contribution. Setting up a new Roth account for each conversion contribution makes it much simpler to reverse a conversion that does not work out.

Required Minimum Distributions Cannot Be Converted

The Roth conversion privilege is still available after a traditional IRA owner has turned age 70½. However, RMD amounts cannot be converted.[13] Therefore, an older client can only convert the amount left in his or her traditional IRA(s) after subtracting the RMD amount for the year of the conversion.

Retirement Plan Balances Can Be Converted

Clients can also make direct (trustee-to-trustee) rollovers of distributions from their tax-deferred qualified retirement plan accounts (such as 401[k] plan accounts, profit-sharing plan accounts, and so forth) into Roth IRAs. In effect, this is just another way to accomplish a Roth conversion. Specifically, the direct retirement account rollover or conversion privilege is allowed for post-2007 distributions from qualified retirement plans, IRC Section 403(b) tax-sheltered annuity arrangements, and governmental IRC Section 457 plans. (Simplified employee pensions [SEPs] and SIMPLE-IRAs can be converted into Roth IRAs simply by recharacterizing the accounts into Roth status.)

As is the case for traditional IRAs, any RMDs coming out of qualified plan accounts cannot be rolled over into a Roth IRA, and the rollover or conversion of a qualified retirement plan account balance is treated as a distribution from the retirement plan account followed by a nondeductible contribution to the Roth IRA. The deemed distribution from the retirement plan account will trigger a current federal income tax hit and often a state income tax

[13] See Treas. Reg. 1.408A-4, Q&A-6.

hit except in the rare case in which the account is worth less than its tax basis from nondeductible contributions.[14]

> **Key Point:** Clients will usually have very limited opportunities to make qualified retirement plan account rollover or conversions because retirement plan distributions are usually only allowed after the participant (your client) retires or separates from service. In contrast, amounts in traditional IRAs can be converted to Roth status at any time. Therefore, the discussion in this chapter focuses almost exclusively on converting traditional IRAs.

Roth Conversion Variables

In evaluating the Roth conversion strategy for a particular client, assumptions must be made, and an adviser must "run the numbers" (a process will be discussed later in this chapter). After running the numbers, the client must understand that the output only represents what might happen. In other words, an adviser provides a projection, not a glimpse into the future that the client can take to the bank. Put yet another way, the projected results of a Roth conversion are only as accurate as the underlying assumptions turn out to be. In reality, only one thing can be predicted with uncanny accuracy: a Roth conversion will almost always trigger an income tax bill that could otherwise be deferred. With that thought in mind, advisers should consider several key variables when assessing the wisdom of the Roth conversion strategy.

Tax Rates on Income Triggered by Conversion

When a Roth conversion is made, the taxable income from the resulting deemed traditional IRA distribution is piled on top of taxable income from all other sources; that is, when a client converts a large IRA, it can push his or her into higher tax rate brackets (possibly much higher). In addition, the conversion income increases the client's AGI, which can trigger a host of unfavorable AGI-based phase-out rules (such as the rules that curtail the child tax credit, the higher education tax credits, the ability to currently deduct passive losses from rental real estate, the tax-free portion of Social Security benefits, and so forth).

The client need not immediately convert the entire balance in a large IRA. For instance, he or she can convert the balance in stages over several years. However, this multi-year conversion strategy is less attractive because the tax rates in post-2012 years are unknown. When the client has several traditional IRAs, he or she can choose to convert only the ones with modest account balances.

Nondeductible Contributions

A client who has made nondeductible contributions to his or her traditional IRA(s) may not understand that he or she cannot simply convert an amount equal to the cumulative nondeductible contributions and thereby avoid any conversion tax hit. In this situation, the

[14] See IRS Notices 2008-30 and 2009-75.

client is considered to convert *pro rata* nontaxable and taxable amounts based on the aggregate balance of all his traditional IRAs (including any SEP-IRAs and SIMPLE-IRAs) and the aggregate amount of all nondeductible contributions to those accounts, regardless of which account or accounts are actually converted. See the discussion earlier in this chapter and example of how nondeductible contributions affect conversions under the account aggregation rule.

Source of Cash to Pay Conversion Tax Hit

When a traditional IRA is converted into a Roth account, the cash to pay the conversion tax hit must come from somewhere. However, it generally should not come from IRAs or other tax-deferred retirement accounts, because if money is withdrawn from such accounts (including the account that is to be converted), the IRC Section 72(t) 10 percent premature withdrawal penalty tax will usually apply if the account owner is under age 59½. The penalty tax will be in addition to the income tax hit on the conversion.

What if the client instead taps into his or her new Roth IRA *after* the conversion to get the cash needed to pay the conversion tax bill? In this case, too, the 10 percent premature withdrawal penalty tax will usually apply if the client is under age 59½.[15] Of course, tapping into the Roth account would also have the negative effect of reducing the account balance, which means less tax-free income will be earned in the future. The whole idea of converting is to maximize the amount of tax-free income earned the future.

> **Key Point:** For the reasons explained previously, clients generally should consider Roth conversions only when they have enough available cash to pay the conversion tax hit without withdrawing money from tax-favored retirement accounts.

Expectations about Retirement-Age Tax Rates

This is when it gets really interesting. The Roth conversion strategy makes the *most* sense when a client expects to be in relatively high income tax brackets during his or her retirement years, because those are the years during which the client would be taking taxable IRA withdrawals if the account under consideration is left in traditional IRA status. Put another way, converting the traditional IRA into a Roth IRA would allow the client to avoid paying high post-retirement tax rates on earnings that accumulate in the account after the conversion.

On the other hand, the conversion strategy makes much less sense if the client expects to pay only 10 percent or 15 percent to the IRS during his or her retirement years.

Expectations about Retirement-Age Financial Position

The Roth conversion strategy makes more sense for clients who will not actually need to take IRA withdrawals during their retirement years. Such well-off individuals may instead prefer to leave their IRAs to their heirs. However, that is difficult to do with traditional IRAs,

[15] See IRC sec. 408A(d)(3)(F).

because the RMD rules force account owners to begin taking RMDs after they reach age 70½. With a Roth IRA, however, no RMDs are required until after the account owner dies. Plus, post-death withdrawals will be federal-income-tax-free to the heirs assuming the withdrawals meet the definition of qualified Roth distributions, which will usually be the case.

Expectations about Rates of Return

The higher the expected rate of return on investments held in the client's IRA, the better the case for conversion. In the absence of healthy future returns, a Roth conversion would simply mean the client prepaid income taxes for no good reason. That would not qualify as wise tax planning.

Planning for Conversions

Multi-Year Conversion Strategy

As explained earlier in this chapter, the taxable income triggered by a client's Roth conversion is combined in with all his or her other ordinary income from salary, self-employment, and so forth. Therefore, converting a traditional IRA with a hefty balance could transport the client into significantly higher tax brackets. The taxable income triggered by the conversion will also bump up the client's AGI, which could trigger a host of unfavorable AGI-based phase-out rules. To avoid these fates, clients can consider converting large traditional IRA balances into Roth status in stages over several years.

Example 3-3

Carmen is a married joint filer. She has a traditional IRA worth $300,000, mainly from rolling over qualified retirement plan distributions from several former jobs. Carmen expects the taxable income on her 2012 joint return to be about $140,000, before counting any additional income that would be triggered by a Roth conversion. Under these facts, Carmen's 2012 marginal federal income tax rate is 25 percent, before considering any conversion income.

If she converts the entire $300,000 balance in her traditional IRA in 2012, almost all of the $300,000 will be taxed at 28 percent, 33 percent, and 35 percent. If Carmen is expecting to pay her normal 25 percent rate, she will be very disappointed. Reporting an extra $300,000 of income in 2012 could also trigger unfavorable AGI-based phase-out rules.

As an alternative, Carmen could choose to convert her traditional IRA balance in stages over several years (for example, $100,000 in 2012, another $100,000 in 2013, and another $100,000 in 2014). The advisability of this strategy depends on some unknown factors, including what tax rates will apply to Carmen in post-2012 years.

Split Large Traditional IRA into Several Accounts before Converting

If a client has a big traditional IRA that he or she wants to convert into a Roth account in 2010, he or she should consider splitting the one big account up into several smaller accounts before converting them all into separate Roth IRAs. Then, he or she can follow different investment strategies for each of the new Roth accounts. If one of the Roth accounts takes

a dive (for example, because it holds stocks that plummet in value), the client can reverse the conversion for that one account while leaving the other better-performing accounts in Roth IRA status. Remember that clients have until October 15, 2013, to reverse any ill-fated 2012 conversions. The issue of reversing Roth conversions is covered in more detail later in this chapter.

Bottom Line on Roth Conversions

As in the past, evaluating the wisdom of doing a Roth conversion depends on assessing several client-specific factors. Conversions generally do not make much sense unless the client (1) expects to pay the same or higher tax rates during retirement, (2) expects to leave the Roth IRA money invested for long enough and at a high enough rate of return to more than recover from the upfront conversion tax hit, and (3) can afford to pay the conversion tax hit from sources other than withdrawals from tax-favored retirement accounts. If these basic criteria are met, 2012 may be the perfect storm for Roth conversions. The following section will provide several Roth conversion case studies.

Roth Conversion Case Studies

The following case studies assume your client is thinking about converting a traditional IRA with a $100,000 balance into a Roth IRA. The account in question could be a SEP-IRA or SIMPLE-IRA because they count as traditional IRAs.

It is important to recognize that the money used to pay the conversion tax bill could otherwise be invested in a taxable brokerage firm account, so the true cost of converting must include the cumulative after-tax investment earnings that are foregone on the dollars spent to pay the conversion tax hit. This factor is taken into account in the case studies.

Case 1: 7 Percent Rate of Return With Same Tax Rate at Retirement in 20 Years

Assumptions: A traditional IRA with a $100,000 balance may be converted to a Roth IRA. The following rates are in effect:

- 7 percent pretax rate of return on IRA balance between now and retirement in 20 years
- 35 percent combined federal and state tax rate on income triggered by Roth conversion
- 35 percent combined tax rate if account is kept in traditional IRA status and liquidated at end of 20 years
- 4.90 percent after-tax rate of return* for 20 years on cash used to pay Roth conversion tax hit (money that could have otherwise been invested in taxable account until retirement).

Future value of tax-free Roth IRA	$386,970
Lost future value of $35,000 conversion tax	(97,390)
Net value of Roth alternative	$289,580
Future value of traditional IRA after taxes	$251,530
Bottom Line: Converting puts client ahead by	$38,050

* Assume cash spent to pay conversion tax hit could have been invested in taxable account at 7 percent annual pretax rate of return. Optimistically assume the entire 7 percent return is from long-term capital gains from assets held for one year and a day and from qualified dividends, both of which are taxed at an optimistic combined federal and state rate of only 25 percent. These optimistic tax assumptions equate to an optimistic 5.25 percent annual after-tax rate of return.

Case 2: 7 Percent Rate of Return With Lower Tax Rate at Retirement in 20 Years

Assumptions: Same as case 1, except now use an optimistic 25 percent retirement-age tax rate if the account is kept in traditional IRA status and liquidated in 20 years.

Future value of tax-free Roth IRA	$386,970
Lost future value of $35,000 conversion tax	(97,390)
Net value of Roth alternative	$289,580
Future value of traditional IRA after taxes	$290,230
Bottom Line: Converting puts client behind by	$650

Reason: It is not so easy to conclude that converting does not pay off, but it can be done by optimistically assuming significantly lower tax rates at retirement. Converting works best when the retirement-age tax rate is the same or higher than the tax rate on income triggered by the conversion. (Compare the outcome in this case to the outcomes in Case 1 and Case 3.)

Case 3: 7 Percent Rate of Return With Higher Tax Rate at Retirement in 20 Years

Assumptions: Same as Case 1, except now use a 45 percent retirement-age tax rate if the account is kept in traditional IRA status and liquidated in 20 years.

Future value of tax-free Roth IRA	$386,970
Lost future value of $35,000 conversion tax	(97,390)
Net value of Roth alternative	$289,580
Future value of traditional IRA after taxes	$212,830
Bottom Line: Converting puts client ahead by	$76,750

Reason: Wow! Converting works really well when the retirement-age tax rate is higher than the current tax rate on income triggered by the Roth conversion. (Compare the outcome in this case to the outcomes in Cases 1 and 2.)

Case 4: 10 Years to Retirement With Same Tax Rate Then and Now

Assumptions: Same as Case 1, except that now the client has only 10 years until his or her expected retirement age.

Future value of tax-free Roth IRA	$196,720
Lost future value of $35,000 conversion tax	(58,380)
Net value of Roth alternative	$138,340
Future value of traditional IRA after taxes	$127,870
Bottom Line: Converting puts client ahead by	$10,470

Reason: Converting still puts the client ahead, but not by nearly as much as when there are more years until retirement. Conversion works best when the client has many years to invest, and thereby earn lots of tax-free Roth IRA profits to compensate for the up-front conversion tax hit. (Compare the outcome in this case to the outcome in Case 1.)

Case 5: 10 Years to Retirement With Higher Tax Rate Then

Assumptions: Same as Case 4, except now use a 45 percent tax rate if the account is kept in traditional IRA status and liquidated after 10 years.

Future value of tax-free Roth IRA	$196,720
Lost future value of $35,000 conversion tax	(58,380)
Net value of Roth alternative	$138,340
Future value of traditional IRA after taxes	$108,196
Bottom Line: Converting puts client ahead by	$30,144

Reason: Converting puts the client way ahead due to the higher retirement-age tax rate. (Compare the outcome in this case to the outcome in Case 4.) Also note that conversion works much better when the client has many years to invest and thereby earn lots of tax-free Roth IRA profits to compensate for the up-front conversion tax hit. (Compare the outcome in this case to the outcome in Case 3.)

Reversing Ill-Fated Roth IRA Conversions

Another taxpayer-friendly aspect of the Roth conversion strategy is that a calendar-year client has until October 15 of the year following the year of a conversion to reverse the conversion. The client has a day or two longer in years when October 15 falls on a weekend. The October 15 deadline for reversals applies whether or not the client extends his or her Form 1040 for the conversion year.[16] For example, the client has until October 15, 2012, to reverse a 2011 conversion and until October 15, 2013, to reverse a 2012 conversion.

Reversal Basics

When the client converts his or her traditional IRA into a Roth account, the transaction is treated as a distribution from the traditional IRA followed by a contribution of the distributed amount to the Roth account. Therefore, the conversion triggers a federal income tax bill (and maybe a state income tax bill, too) based on the traditional IRA's value on the conversion date.

> **Key Point:** The client effects the reversal by *recharacterizing* the account back to traditional IRA status. This is done by turning in the proper form to the Roth IRA trustee or custodian. For example, Schwab's version of this form is called "IRA Recharacterization Letter of Authorization."

[16] See IRC sec. 408A(d)(6) and (7) and Treas. Reg. 301.9100-2(b).

Example 3-4

Ken converts two traditional IRAs into Roth accounts in 2012. One of the accounts does well but the other account plummets due to poor performance of equity investments. In this unhappy situation, Ken would have to pay income tax on account value that has now disappeared. Thankfully, however, Ken has until October 15, 2013, to recharacterize the devalued account back to traditional IRA status. After the recharacterization, it is as if the ill-fated conversion never happened, so Ken will not owe any income tax on the 2012 conversion that is reversed in 2013. In other words, the 2012 conversion is reversed with no tax harm done.

Key Point: Ken can leave the converted account that is performing well in tax-free Roth IRA status.

What If Roth IRA Has Other Contributions?

Things are a bit more complicated if the client's Roth IRA includes other contributions in addition to the conversion contribution that he or she now wants to reverse. In this case, it may not be possible to simply recharacterize the entire Roth account back to traditional IRA status. For instance, if the Roth IRA includes contributions for pre-2011 tax years, it is way too late to recharacterize the part of the Roth IRA balance that is attributable to those contributions back to traditional IRA status. However, up to the October 15, 2012, deadline, the client can still reverse an ill-fated 2011 conversion contribution by telling the IRA trustee or custodian to move that contribution (along with the related losses) back into a traditional IRA.[17]

> **Key Point:** Under these circumstances, the client once again accomplishes the reversal by turning in the proper form to the Roth IRA trustee or custodian. The client will have to specify that the conversion contribution amount minus the amount of related losses is to be moved back into a traditional IRA. The client can usually allow the trustee or custodian to calculate the amount of the related losses.

Reporting Reversals

The traditional IRA's trustee or custodian should report to the client, and to the IRS, the deemed distribution that results from a 2011 Roth conversion on Form 1099-R (Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.). If the client has not yet filed his or her 2011 Form 1040, simply enter the Form 1099-R distribution amount on line 15a. Then enter a taxable amount of zero on line 15b. These two entries show that your client had a 2011 conversion and a later reversal, with the net result of zero 2011 taxable income. If the client has already filed his or her 2011 Form 1040, he or she will need to file an amended return, using Form 1040X (Amended U.S. Individual Income Tax Return), to show the reversal and collect his or her rightful tax refund.

The reversal transaction will itself trigger yet another Form 1099-R from the Roth IRA trustee or custodian to report the deemed distribution from recharacterizing the Roth account back to traditional IRA status. So, if the reversal of the 2011 conversion occurs in 2012, enter the Form 1099-R distribution amount on line 15a of the client's 2012 Form

[17] See Treas. Reg. 1.408A-5.

1040. Then, enter a taxable amount of zero on line 15b. These two entries show that the client had a reversal that did not result in any 2012 taxable income. (This advice assumes the relevant lines on the 2012 version of Form 1040 are the same as on the 2011 version.)

Reconverting After Reversals

Following the recharacterization of a devalued Roth account back to traditional IRA status (in other words, the reversal of an earlier Roth conversion), the client can still *reconvert* the same account back to Roth status for all the good reasons explained earlier in this chapter. This time around, however, the conversion tax hit will be lower (all other things being equal), because the account is worth less than before.

However, there are timing restrictions on the reconversion privilege. After an account has been recharacterized back to traditional IRA status, it cannot be reconverted to Roth status until the later of (1) January 1 of the year following the year within which the account was originally converted to Roth status or (2) 30 days after the date the account was reversed (recharacterized) back to traditional IRA status.[18]

Example 3-5

Linda originally converted her traditional IRA into a Roth in 2011 when the stock market seemed to be regaining its health. Then, the account took a big nosedive, so she recharacterizes it back to traditional IRA status on September 1, 2012, to avoid an inflated 2011 conversion tax hit. The earliest she can reconvert the account back into a Roth IRA is October 1, 2012 (30 days after the recharacterization date).

Example 3-6

Max converts his traditional IRA into a Roth account in July of 2012 and then reverses it back to traditional IRA status in November 2012. The earliest he can reconvert the account back into a Roth IRA is January 1, 2013 (January 1 of the year following the year during which the account was originally converted into a Roth IRA).

Projecting Retirement Savings Results From Using Tax-Deferred Retirement Accounts, Taxable Accounts, and Roth IRAs

In the current environment, should clients save for retirement using the traditional approach of making annual contributions to a tax-deferred retirement plan, or would annual contributions to a taxable brokerage firm account be better? Where do Roth IRAs fit into the picture? The following sections provide some baseline thoughts followed by some analysis.

[18] See Treas. Reg. 1.408A-5, Q&A-9.

Higher Future Taxes Are Possible

As previously indicated, higher federal income tax rates are scheduled to take effect in 2013. As for state income tax rates, they are already on the rise all over, and the trend is likely to continue.

Therefore, the traditional belief that most folks will pay significantly lower income tax rates during their retirement years may prove to be an obsolete concept. Retirement-age tax rates might turn out to be about the same, or they might be higher (maybe much higher for some affluent individuals).

Cash Is King

For many reasons, it is a really good idea right now to have easy access to cash. Before retirement age, however, it is not so easy to access cash that was put into a tax-deferred retirement account back out again without triggering adverse consequences, because there are restrictions on retirement account withdrawals before separation from service (this is not a problem with IRAs). Then, there is the 10 percent premature withdrawal penalty tax that usually applies to withdrawals before age 59½ and the ordinary income tax treatment for withdrawals, even those that are attributable to capital gains and dividends. All these things make it harder and more painful for clients to get their hands on tax-deferred retirement account funds if cash suddenly becomes needed in this lousy economy.

Therefore, clients who are employees should probably be more worried than in the past about the advisability of continuing the conventional-wisdom strategy of maxing out on annual salary-deferral contributions to company retirement plans. (The notable exception is when employee contributions trigger significant employer matching contributions, assuming those matching contributions will become vested before the employee leaves.) Likewise, self-employed clients should probably be more worried than in the past about continuing the conventional-wisdom strategy of maxing out on annual contributions to their tax-deferred retirement plans.

Roth IRAs Provide "Insurance" Against Bad Outcomes

In effect, a Roth IRA can function as an insurance policy against some of the bad outcomes that can easily occur with tax-deferred retirement accounts in the following ways:

1. The client has complete control over funds held in a Roth IRA. This is not the case when funds are sequestered in an employer-sponsored retirement plan (this is not a problem with IRAs).
2. The client does not have to worry so much about the 10 percent premature withdrawal penalty tax with a Roth IRA. The tax can only hit premature withdrawals of Roth account earnings and premature withdrawals of Roth conversion contributions that are taken out within 5 years. In other words, the client can always withdraw up to the total amount of his or her annual Roth contributions tax-free and penalty-free. Then, he

or she can withdraw any conversion contributions tax-free and penalty-free after only 5 years, even if he or she is way under age 59½.

3. The client does not have to worry so much about the possibility (or probability) of higher future federal income tax rates with a Roth IRA. Roth withdrawals are federal-income-tax-free as long as they meet the definition of qualified Roth withdrawals. In general, a qualified Roth withdrawal is one that occurs after (1) the client has reached age 59½ (or has died or become disabled) and (2) the client has had at least one Roth IRA open for more than 5 years.
4. Last, but not necessarily least, the client does not have to worry at all about the RMD rules with a Roth IRA, because Roth IRAs (other than inherited Roth accounts) are completely exempt from the RMD rules.

Circumventing the Income Restriction on Annual Roth Contributions

Unfortunately, the privilege of making annual Roth contributions is phased out when MAGI exceeds certain levels. For 2012, the MAGI phase-out ranges are $110,000–$125,000 for unmarried individuals; $173,000–$183,000 for married joint-filing couples; and $0–$10,000 for married individuals who file separately.

For this purpose, *MAGI* is defined as "regular AGI" minus any income from RMDs taken from traditional IRAs, with the following amounts then added back:

- Deductible traditional IRA contributions
- Tax-free interest from U.S. Savings Bonds redeemed to pay education costs under IRC Section 135
- Tax-free adoption assistance from an employer under IRC Section 137
- The deduction for domestic production activities under IRC Section 199
- The deduction for student loan interest under IRC Section 221
- The deduction for tuition and related fees under IRC Section 222
- Any exclusions for foreign earned income and housing allowances under IRC Sec. 911[19]

However, it will often be possible to work around the income restriction, as previously discussed in the section "High-Income Clients Can Circumvent MAGI Restriction on Annual Roth Contributions," in this chapter.

> **Warning:** If the client has one or more *existing* traditional IRAs, converting the new nondeductible traditional IRA into Roth status will usually *not* be a tax-free maneuver, which may douse any enthusiasm for the whole idea. See the discussion earlier in this chapter of how nondeductible contributions affect conversions under the account aggregation rule.

[19] See IRC secs. 408A(c)(3)(B) and 219(g)(3).

Run Scenarios to Compare Retirement Savings Results

Although the preceding considerations seem to weigh against continuing the conventional-wisdom strategy of making tax-deferred retirement accounts the first choice for retirement savings vehicles, advisers should still run the numbers in different scenarios to see what truths are revealed.

Global Assumptions for Scenarios

In all the retirement savings scenarios that follow, assume your client is assessing whether to contribute the same amount of after-tax dollars to one of the following options:

- Option A: tax-deferred retirement plan account with no employer matching
- Option B: taxable brokerage firm account
- Option C: Roth IRA

In all the scenarios, also assume a 35 percent combined federal and state marginal income tax rate for the contribution year.

Results from Sample Scenarios

Consider the results from the following scenarios.

Scenario 1: Invest Savings for 20 Years and Pay Lower Retirement-Age Tax Rate

Option A (Tax-Deferred Retirement Account): Client contributes $10,000, invests for 20 years at a 7 percent annual rate of return, and pays a 30 percent combined federal and state tax income rate when account is liquidated at retirement age.

Outcome = $27,088: Client has $27,088 left after liquidating account and paying taxes.

Option B (Taxable Brokerage Firm Account): Client contributes $6,500 (same after-tax cost as $10,000 deductible contribution to tax-deferred account) and invests for 20 years at a 7 percent pretax annual rate of return, which equates to a 5.25 percent after-tax rate. (Optimistically assume the entire 7 percent annual return is from long-term capital gains from assets held for exactly one year and a day and from qualified dividends, both of which are taxed each year at a combined 25 percent rate; 0.75% × 7% = 5.25%.)

Outcome = $18,087: After paying taxes every year (at a super-optimistic rate), client is left with only $18,087, which is way less than under the other alternatives. Not good!

Option C (Roth IRA): Client contributes $6,500 to Roth IRA (same after-tax cost as $10,000 deductible contribution to tax-deferred account), invests for 20 years at a 7 percent annual rate of return, and pays $0 in taxes when account is liquidated. (Client is married, and client and spouse can together contribute $10,000.)

Outcome = $25,153: Client has $25,153 after liquidating account and paying $0 in taxes. Not as much as with the tax-deferred account alternative, but pretty close.

Comments: This scenario is based on what might be called traditional assumptions about what the future holds for retirement savers. The tax-deferred retirement account alternative wins in this scenario because it starts off with so much more money invested and because taxes on its earnings are deferred and ultimately paid at a lower rate.

Scenario 2: Invest Savings for 20 Years and Pay Higher Retirement-Age Tax Rate

Option A (Tax-Deferred Retirement Account): Client contributes $10,000, invests for 20 years at a 7 percent annual rate of return, and pays a 40 percent combined federal and state tax income rate when account is liquidated at retirement age.

Outcome = $23,218: Client has $23,218 left after liquidating account and paying taxes.

Option B (Taxable Brokerage Firm Account): Client contributes $6,500 (same after-tax cost as $10,000 deductible contribution to tax-deferred account) and invests for 20 years at a 7 percent pretax annual rate of return, which equates to a 5.25 percent after-tax rate. (Optimistically assume the entire 7 percent pretax return is from long-term capital gains from assets held for exactly one year and a day and from qualified dividends, both of which are taxed each year at a combined 25 percent rate; 0.75% × 7% = 5.25%.)

Outcome = $18,087: After paying taxes every year (at a super-optimistic rate), client is left with only $18,087, which is way less than under the other alternatives. Not good!

Option C (Roth IRA): Assume client contributes $6,500 to Roth IRA (same after-tax cost as $10,000 deductible contribution to tax-deferred account), invests for 20 years at 7 percent annual rate of return, and pays $0 in taxes when account is liquidated at retirement age. (Client is married, and client and spouse can together contribute $10,000.)

Outcome = $25,153: Client has $25,153 after liquidating account and paying $0 in taxes.

Comments: This scenario is based on a pessimistic assumption about taxes on retirement-age withdrawals from the tax-deferred account. The Roth IRA alternative wins in this scenario, because it insures against higher retirement-age tax rates.

Scenario 3: Invest Savings for Only 10 Years and Pay Higher Tax Rate Plus 10 Percent Premature Withdrawal Penalty Tax

Option A (Tax-Deferred Retirement Account): Client contributes $10,000, invests for only 10 years at a 7 percent annual rate of return, and pays a 50 percent combined federal and state tax income rate (40 percent plus 10 percent premature withdrawal penalty tax) when account is liquidated prematurely.

Outcome = $9,836: Client has only $9,836 left after prematurely liquidating account and paying confiscatory taxes. This is less than he or she started with. This is terrible!

Option B (Taxable Brokerage Firm Account): Client contributes $6,500 (same after-tax cost as $10,000 deductible contribution to tax-deferred account) and invests for 10 years at a 7 percent pretax annual rate of return, which equates to 5.25 percent after-tax rate. (Optimistically assume the entire 7 percent annual return is from long-term capital gains from assets held for exactly one year and a day and from qualified dividends, both of which are taxed each year at a combined 25 percent rate; 0.75% × 7% = 5.25%.)

Outcome = $10,843: After paying taxes every year, client is left with $10,843. Not bad, but remember this involved a super-optimistic tax rate assumption.

Option C (Roth IRA): Client contributes $6,500 to Roth IRA (same after-tax cost as $10,000 deductible contribution to tax-deferred account), invests for 10 years at a 7 percent annual rate of return, and pays a 50 percent tax rate (including 10 percent penalty tax) on earnings when account is liquidated prematurely. (Client is married, and client and spouse can together contribute $10,000.)

Outcome = $9,643: Client has only $9,643 after liquidating account and paying confiscatory 50 percent tax rate on earnings. Not good!

Comments: This scenario is based on a very pessimistic assumption about taxes on withdrawals from the tax-deferred retirement account and the Roth IRA. The taxable account alternative wins in this scenario because it involved a super-optimistic tax assumption (maybe too optimistic).

Scenario 4: Invest Savings for 20 Years at Low Rate of Return and Pay Lower Retirement-Age Tax Rate

Option A (Tax-Deferred Retirement Account): Client contributes $10,000, invests for 20 years at a 3.5 percent annual rate of return and pays a 0 percent combined federal and state tax income rate when account is liquidated at retirement age.

Outcome = $13,929: Client has $13,929 left after liquidating account and paying taxes.

Option B (Taxable Brokerage Firm Account): Client contributes $6,500 (same after-tax cost as $10,000 deductible contribution to tax-deferred account) and invests for 20 years at a 3.5 percent pretax annual rate of return, which equates to a 2.63 percent after-tax rate. (Optimistically assume the entire 3.5 percent annual return is from long-term capital gains from assets held for exactly one year and a day and from qualified dividends, both of which are taxed each year at a combined 25 percent rate; 0.75% × 3.5% = 2.63%.)

Outcome = $10,924: After paying taxes every year (at a super-optimistic rate), client is left with only $10,924, which is way less than under the other alternatives. Not good!

Option C (Roth IRA): Client contributes $6,500 to Roth IRA (same after-tax cost as $10,000 deductible contribution to tax-deferred account), invests for 20 years at a 3.5 percent annual rate of return, and pays $0 in taxes when account is liquidated. (Client is married, and client and spouse can together contribute $10,000.)

Outcome = $12,934: Client has $12,934 after liquidating account and paying $0 in taxes. Not as much as with the tax-deferred account alternative, but pretty close.

Comments: This scenario is based on a pessimistic rate-of-return assumption combined with optimistic tax assumptions. The tax-deferred retirement account alternative wins in this scenario because it starts off with so much more money invested and because taxes on its earnings are deferred and ultimately paid at a lower rate.

Scenario 5: Invest Savings for 20 Years at Low Rate of Return and Pay Higher Retirement-Age Tax Rate

Option A (Tax-Deferred Retirement Account): Client contributes $10,000, invests for 20 years at a 3.5 percent annual rate of return, and pays a 40 percent combined federal and state tax income rate when account is liquidated at retirement age.

Outcome = $11,939: Client has $11,939 left after liquidating account and paying taxes.

Option B (Taxable Brokerage Firm Account): Client contributes $6,500 (same after-tax cost as $10,000 deductible contribution to tax-deferred account) and invests for 20 years at a 3.5 percent pretax annual rate of return, which equates to a 2.63 percent after-tax rate. (Optimistically assume the entire 3.5 percent pretax return is from long-term capital gains from assets held for exactly one year and a day and from qualified dividends, both of which are taxed each year at a combined 25% rate; 0.75% × 3.5% = 2.63%.)

Outcome = $10,924: After paying taxes every year (at a super-optimistic rate), client is left with only $10,924, which is considerably less than under the other alternatives. Not good!

Option C (Roth IRA): Client contributes $6,500 to Roth IRA (same after-tax cost as $10,000 deductible contribution to tax-deferred account), invests for 20 years at a 3.5 percent annual rate of return, and pays $0 in taxes when account is liquidated. (Client is married, and client and spouse can together contribute $10,000.)

Outcome = $12,934: Client has $12,934 after liquidating account and paying $0 in taxes.

Comments: This scenario is based on a pessimistic rate-of-return assumption combined with a pessimistic assumption about taxes on withdrawals from the tax-deferred retirement account. The Roth IRA alternative wins in this scenario because it insures against higher retirement-age tax rates.

Scenario 6: Invest Savings for Only 10 Years at Low Rate of Return and Pay Higher Tax Rate Plus 10 percent Premature Withdrawal Penalty Tax

Option A (Tax-Deferred Retirement Account): Client contributes $10,000, invests for only 10 years at a 3.5 percent annual rate of return, and pays a confiscatory 50 percent combined federal and state tax income rate (40 percent plus 10 percent premature withdrawal penalty tax) when account is liquidated prematurely.

Outcome = $7,053: Client has only $7,053 left after prematurely liquidating account and paying confiscatory taxes. This is way less than he or she started with. This is an outright disaster!

Option B (Taxable Brokerage Firm Account): Assume client contributes $6,500 (same after-tax cost as $10,000 deductible contribution to tax-deferred account) and invests for 10 years at a 3.5 percent pretax annual rate of return, which equates to 2.63 percent after-tax rate. (Optimistically assume the entire 3.5 percent annual return is from long-term capital gains from assets held for exactly one year and a day and from qualified dividends, both of which are taxed each year at a combined 25 percent rate; 0.75% × 3.5% = 2.63%.)

Outcome = $8,427: After paying taxes every year, client is left with $8,427. At least this is more than he or she started with. However, remember that a super-optimistic tax assumption is involved.

Option C (Roth IRA): Client contributes $6,500 to Roth IRA (same after-tax cost as $10,000 deductible contribution to tax-deferred account), invests for 10 years at a 3.5 percent annual rate of return, and pays a 50 percent tax rate (including 10 percent penalty tax) on earnings when account is liquidated prematurely. (Client is married, and client and spouse can together contribute $10,000.)

Outcome = $7,835: Client has only $7,835 after liquidating account and paying 50 percent tax rate on earnings. Not good!

Comments: This scenario is based on a very pessimistic assumption about taxes on tax-deferred retirement account and Roth IRA withdrawals combined with a pessimistic rate-of-return assumption. The taxable account alternative wins in this scenario because of the super-optimistic tax assumption (maybe too optimistic).

What Can We Conclude Here?

The numbers in the preceding scenarios are based on assumptions. It is possible to prove just about anything by manipulating the assumptions, so please take the numbers for what they are worth. With those thoughts in mind, the following are observations about the three retirement savings alternatives considered in this analysis.

Tax-Deferred Retirement Accounts

Not surprisingly, the tax-deferred retirement account option (Option A) wins when making more or less traditional assumptions about the future (Scenarios 1 and 4). Clients who still feel comfortable with such assumptions can feel comfortable about continuing the conventional-wisdom strategy of maxing out on contributions to tax-deferred retirement plans. Of course, more or less traditional assumptions could turn out to be horribly wrong with terrible results (Scenarios 3 and 6). Fortunately, an adviser's job is limited to helping clients decide what they want to believe and then showing them the projected results.

Taxable Brokerage Firm Accounts

Not surprisingly, the taxable retirement savings account option (Option B) wins when forecasting super-optimistic tax rates and confiscatory tax rates on withdrawals from tax-deferred retirement accounts and Roth IRAs (Scenarios 3 and 6). What *is* surprising is how miserably the taxable account alternative performs in the other scenarios, in which it always finishes dead last and by considerable margins. Once again, an adviser's job is limited to helping clients decide what they want to believe and then showing them the projected results.

Roth IRAs

Not surprisingly, the Roth IRA option (Option C) wins easily when anticipating higher future income tax rates and no premature withdrawals (Scenarios 2 and 5). The Roth option finishes a respectable second in three out of the other four scenarios (Scenarios 1, 4, and 6). All things considered, the Roth option looks better and better, because it makes outright tax avoidance perfectly legal, and it provides some valuable "insurance" advantages to boot.

Self-Employed Clients Should Not Overlook Chance to Make Annual Roth IRA Contributions

Saving more for retirement is something nearly everyone should try to do. When it can be done in a tax-smart fashion, so much the better! Making annual contributions to a Roth IRA is definitely tax-smart, because the account owner can take federal-income-tax-free withdrawals after reaching age 59½. Of course, Roth contributions are nondeductible, but that is acceptable because the tax savings are reaped on the back end of the deal.[20]

Fairly affluent self-employed clients may have dismissed the idea of making annual Roth contributions for two wrong-headed reasons.

1. The client figures his or her income is too high to qualify for annual Roth contributions, which may not be true, as discussed subsequently.
2. Even when the client is eligible for annual Roth contributions, he or she is uninterested because he or she believes he or she will be in a higher tax bracket now than during

[20] See IRC sec. 408A.

his or her retirement years. Therefore, the client has not even bothered to think about the possibility of making annual Roth contributions. Instead, he or she has focused on the conventional-wisdom strategy of "maxing out" on annual deductible contributions to his or her traditional tax deferred self-employed retirement arrangement (SEP, solo 401[k], SIMPLE-IRA, and so on). In general, maxing out is well and good, but the client should also consider making annual Roth contributions, because there is no downside. The upside of making Roth contributions is the opportunity to build up a fairly substantial federal-income-tax-free retirement fund. In addition, it may turn out that the client is dead wrong about being in a lower tax bracket during retirement. If so, making annual Roth contributions will look really smart with hindsight.

If a client qualifies for annual Roth contributions, he or she should be making them, assuming he or she has the requisite cash. The following section will take a closer look at the two objections listed previously so you can fully understand the issues and explain them to clients.

Key Point: For 2012, the maximum annual Roth IRA contribution is $5,000, or $6,000 if the individual is age 50 or older at the end of the year. (Note that making annual Roth contributions has no impact on eligibility for the Roth conversion privilege.)

Client's Income Is Too High for Annual Roth Contributions (That May Be Wrong)

The privilege of making annual Roth contributions is phased out or completely eliminated if MAGI exceeds certain levels. The phase-out ranges for 2012 Roth contribution privileges are shown in box 3-1.

Box 3-1: 2012 Roth Contribution Phase-Out Ranges

Unmarried individual modified adjusted gross income (MAGI) phase-out range	$110,000–$125,000
Married joint filer MAGI phase-out range	$173,000–$183,000
Married filing separate phase-out range	$0–$10,000

At first glance, the figures in box 3-1 do make it look as if a self-employed person with a robust income from his or her business is unlikely to be eligible for annual Roth contributions. Not so fast! A self-employed individual's MAGI is likely to be considerably lower than the MAGI of an employee who is in roughly equivalent circumstances, because a successful self-employed individual will often have hefty above-the-line deductions for (1) deductions for an office in the home, (2) contributions to a tax-deferred retirement plan (typically, a SEP, defined contribution Keogh plan, or solo 401[k] plan), (3) health insurance premiums, and (4) the writeoff for 50 percent of self-employment tax. These above-the-line deductions, which are only available to self-employed folks, are all subtracted in arriving at MAGI.

Therefore, a self-employed person can have a relatively high net income from his or her business, while having a surprisingly low MAGI.

> **Key Point:** See the section "Circumventing the Income Restriction on Annual Roth Contributions" in this chapter for a definition of MAGI for purposes of the MAGI restriction on annual Roth contributions.[21]

> **Key Point:** After taking their rightful above-the-line deductions into account, many self-employed individuals will be surprised to discover that they do indeed qualify to make annual Roth IRA contributions. The following examples illustrate the point.

Example 3-7

Ned is a married sole proprietor who files jointly with his spouse, Nancy, who stays home to take care of the couple's two children. Their joint 2012 MAGI is calculated as follows.

Schedule C gross income from Ned's business	$230,000
Schedule C expenses (including office in home)	(20,000)
Deduction for self-employment tax	(9,638)*
Deduction for maximum allowable SEP contribution	(40,072)**
Deduction for family health insurance premiums	(10,000)
Income from interest, dividends, and capital gains	18,000
MAGI	$168,290

Because the couple's joint MAGI is less than the $173,000 phase-out threshold for 2012, Ned is fully eligible to make a 2012 Roth IRA contribution despite the relatively high income from his business. Nancy is fully eligible too. Therefore, Ned and Nancy could each contribute up to $5,000 to Roth IRAs set up in their respective names (total contributions of $10,000). If Ned is age 50 or older as of December 31, 2012, he can contribute up to $6,000, and Nancy can, too, if she is also age 50 or older (total contributions of $12,000).

Key Point: There is no downside to Ned making a Roth contribution because he can't contribute any more to his SEP, and he is ineligible to make a deductible contribution to a traditional IRA (the couple's joint MAGI is too high for that). Nancy has the option of contributing to either a Roth IRA or making a deductible contribution to a traditional IRA (the couple's joint MAGI allows either choice, but the Roth choice is probably the better one).

* ([$230,000 – 20,000] × 0.9235 × 0.029 × 0.5) + [$110,100 × 0.124 × 0.5]) = $9,638

** ($230,000 – 20,000 – 9,638) × 0.20 = $40,072

[21] See IRC secs. 408A(c)(3)(C) and 219(g)(3).

Example 3-8

Beth is an unmarried sole proprietor. Her 2012 MAGI is calculated as follows.

Schedule C gross income from the business	$160,000
Schedule C expenses (including office in home)	(15,000)
Deduction for self-employment tax	(8,768)*
Deduction for maximum allowable SEP contribution	(27,246)**
Deduction for health insurance premiums	(9,000)
Income from interest, dividends, and capital gains	10,000
MAGI	$109,986

Because Beth's MAGI is less than the $110,000 phase-out threshold for 2012, she is fully eligible to make a 2012 Roth contribution despite the relatively high income from her business. Therefore, Beth can contribute up to $5,000 to a Roth IRA. If she is age 50 or older as of December 31, 2012, she can contribute up $6,000.

Key Point: There is no downside to Beth making a Roth contribution because she cannot contribute any more to her SEP, and she is ineligible to make a deductible contribution to a traditional IRA (her MAGI is too high for that).

* [($160,000 − 15,000] × 0.9235 × 0.029 × 0.5) + [$110,100 × 0.124 × 0.5]) = $8,768

** ($160,000 − 15,000 − 8,768) × 0.20 = $27,246

Plan B May Allow High-Income Clients to Circumvent Restriction on Annual Roth Contributions

If the self-employed client's MAGI is in fact too high to permit annual Roth contributions, consider whether following "Plan B" might fix the problem. Plan B is available for 2010 and beyond, thanks to the removal of the previous income restriction on Roth conversions, as previously discussed in the section "High-Income Clients Can Circumvent MAGI Restriction on Annual Roth Contributions," in this chapter.[22] In the context of this section, the earned income limitation will usually not be an issue.

> **Warning:** If the client has one or more *existing* traditional IRAs (including an existing SEP account or SIMPLE-IRA) converting the new nondeductible traditional IRA into Roth status will usually *not* be a tax-free maneuver, which may douse any enthusiasm for the whole idea. See the discussion earlier in this chapter of how nondeductible contributions affect conversions under the account aggregation rule.

[22] See IRC secs. 408(A)(c)(2) and 219(c)(1).

Roth Contributions Are Less Attractive Than Deductible Retirement Plan Contributions (That May Be Wrong Too)

Clearly, it is a good thing that your client can deduct annual contributions to a tax-deferred retirement plan set up for his or her self-employed business (such as a SEP plan). However, that does not necessarily mean that such contributions are preferable to contributing the same annual amounts to a Roth IRA instead. For proof, see the discussion in the preceding section.

As long as the client's retirement savings game plan includes the following two assumptions, he or she will probably not be badly harmed by making annual deductible contributions to a tax-deferred retirement plan instead of making annual nondeductible Roth contributions:

- *Assumption No. 1.* The client will take the tax savings from making annual deductible retirement plan contributions and either invest the money in a taxable retirement savings account or use the money to make bigger annual deductible retirement plan contributions.
- *Assumption No. 2.* The client expects to be in a lower tax bracket during his or her retirement years.

In real life, the client may not be disciplined enough make Assumption No. 1 a valid proposition. Assumption No. 2 also looks highly debatable after taking the federal budget deficit and political environment into account. If it turns out that the client actually pays higher tax rates during his or her retirement years, the client will wish he or she had made annual Roth contributions when he or she had the chance.

> **Key Point:** Even if both of the assumptions pan out, the client should still make annual Roth contributions if he or she has cash left over after maxing out on deductible contributions to his or her tax-deferred retirement plan. In other words, your client should not just do one thing or the other. He or she should do both!

How to Handle Roth IRA Withdrawals

Clients who own Roth IRAs may be under the mistaken impression that withdrawals are always federal-income-tax-free. Not true. Even worse, some withdrawals can get socked with a 10 percent premature withdrawal penalty tax. The following section will discuss, in plain English, what clients (and you) need to know about the federal income tax implications of pulling money out of Roth accounts.

The Simplest Case: Qualified Withdrawals

If the client is age 59½ or older and has had at least 1 Roth IRA open for more than 5 years, any withdrawals from any of his or her Roth IRAs are *qualified withdrawals*. As such, they are

free of any federal income tax or penalty. The 5-year period for qualified withdrawals starts on January 1 of the first tax year for which the client makes a Roth contribution.

Example 3-9

Earliest Date for Tax-Free Roth Withdrawals

Jorge established his first Roth IRA with a regular annual contribution on April 15, 2008. The contribution was for the 2007 tax year. His 5-year period started on January 1, 2007, even though his initial contribution was actually made in 2008. Anytime on or after January 1, 2012, Jorge can take federal-income-tax-free qualified withdrawals from any and all Roth IRAs that he owns, as long as he is 59½ or older. For instance, if Jorge opened up a second Roth account in 2009 by converting a traditional IRA, he can take tax-free qualified withdrawals from that second account anytime on or after January 1, 2012, as long as he is at least 59½.

Tax Reporting for Qualified Withdrawals

When a client takes a qualified withdrawal, he or she should receive a Form 1099-R from the Roth IRA trustee. Box 1 of the Form 1099-R should report the gross withdrawal amount. Often, Box 2b will be checked to indicate the trustee has declined to determine the taxable amount (if any). However, if the trustee believes it was a qualified withdrawal, Box 2 could report a taxable amount of zero. If the trustee believes it was a qualified withdrawal, Box 7 of Form 1099-R should report distribution code Q (qualified distribution).

According to the 2011 Form 1040 instructions, when a qualified withdrawal is reported with code Q in box 7 of Form 1099-R, the total amount of the qualified withdrawal should be reported on line 15a of Form 1040, and zero should be reported on line 15b, because qualified withdrawals are federal-income-tax-free. Presumably, the same treatment applies to a qualified withdrawal when the trustee fails to enter code Q in box 7 of Form 1099-R.

More Complicated Cases: Nonqualified Withdrawals

A nonqualified withdrawal is potentially subject to federal income tax. In addition, early nonqualified withdrawals (that is, before age 59½) are potentially subject to a 10 percent premature withdrawal penalty tax, as well. Nonqualified withdrawals can occur in two scenarios: (1) when the account owner is under age 59½ and (2) when the account owner fails to satisfy the 5-year rule.

Scenario 1: Nonqualified Withdrawal Because Client Is Under 59½

Any Roth withdrawal taken before age 59½ is a *nonqualified withdrawal*, by definition. The lone exception is when the special first-time home purchase rule explained later in this chapter applies to a withdrawal taken before age 59½. As such, the withdrawal is potentially, but not necessarily, subject to federal income tax and a 10 percent premature withdrawal penalty tax. In this scenario, nonqualified withdrawals are deemed to come from four layers. Different federal income tax rules apply to each layer.

Key Point: If you have several Roth IRAs, you must aggregate them (that is, add them together and treat them as a single account) to determine which layer(s) each withdrawal comes from and the resulting tax consequences.[23]

Layer No. 1

Nonqualified withdrawals are deemed to come first from the layer consisting of annual Roth contributions (Layer No. 1). Withdrawals from Layer No. 1 are always federal-income-tax-free and penalty-free.

To figure out how much is in Layer No. 1, add up the annual contributions to all Roth IRAs set up in a client's name. (Ignore any Roth accounts in the client's spouse's name.) To prove that the client does not owe any federal income tax or penalty from his or her Layer No. 1 withdrawal, fill out Part III of Form 8606.

Layer No. 2

Nonqualified withdrawals are deemed to come from the layer consisting of the *taxable portion* of a client's Roth conversion contributions, if any (Layer No. 2). Conversion contributions come from converting a traditional IRA into a Roth or from contributing a retirement plan payout (such as from a 401[k] account) to a Roth. The taxable portion of a conversion contribution is the amount of taxable income that was triggered by the contribution (the total contribution minus any nondeductible contributions included in that amount).

To figure out how much is in Layer No. 2, add up all the taxable conversion contribution amounts to all Roth IRAs set up in a client's name. (Again, ignore any accounts in the client's spouse's name.)

Withdrawals from Layer No. 2 are always federal-income-tax-free, but the client could still get hit with the 10 percent premature withdrawal penalty tax. Specifically, the 10 percent penalty tax hits any amount withdrawn from Layer No. 2 within 5 years of the conversion contribution unless an IRA exception to the penalty tax is available. The 5-year period is deemed to begin on January 1 of the year during which the conversion contribution occurred.[24] If the client made several conversion contributions, use first-in-first-out to determine which contribution the withdrawal comes from for purposes of applying the 5-year rule.[25]

To prove that the client does not owe any income tax from the Layer No. 2 withdrawal, fill out Part III of Form 8606. If he or she owes the 10 percent penalty tax, fill out Form 5329 (Additional Taxes on Qualified Plans. [Including IRAs] and Other Tax-Favored Accounts) and enter the penalty tax on line 58 of Form 1040.

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[23] See IRC sec. 408A(d)(4) and Reg. 1.408A-6, Q&A-8.

[24] See IRC secs. 408A(d)(3)(F) and 72(t).

[25] See Treas. Reg. 1.408-6, Q&A-8.

Layer No. 3

Nonqualified withdrawals are deemed to come from the layer consisting of the *nontaxable portion* of a client's Roth conversion contributions, if any (Layer No. 3). Conversion contributions come from converting a traditional IRA into a Roth or from contributing a retirement plan payout (such as from a 401[k] account) to a Roth. The nontaxable portion of a conversion contribution is the amount of nondeductible contributions included in that contribution.

To figure out how much is in Layer No. 3, add up all the nontaxable conversion contribution amounts to all Roth IRAs set up in the client's name. (Again, ignore any accounts in the client's spouse's name.) Withdrawals from Layer No. 3 are always federal-income-tax-free and penalty-tax-free. To prove that he or she does not owe any income tax from the Layer No. 3 withdrawal, fill out Part III of Form 8606.

Layer No. 4

Any further nonqualified withdrawals from Roth accounts set up in a client's name, after he or she has sucked out all his or her contributions, are deemed to come from the layer consisting of Roth IRA earnings (Layer No. 4). Nonqualified withdrawals from Layer No. 4 are always 100 percent taxable.

Fill out Part III of Form 8606 to calculate the taxable amount from this layer, and enter that amount on Line 15b of Form 1040. In addition, the 10 percent premature withdrawal penalty tax applies to nonqualified withdrawals taken from this layer unless the client is eligible for an IRA exception to the penalty tax.[26] If he or she owes the penalty tax, fill out Form 5329 and enter the penalty tax on line 58 of Form 1040.

Example 3-10

Ordering Rules for Early Roth Withdrawals

In 2005, Edna (now age 51), converted her traditional IRA worth $30,000 into a Roth account. The entire conversion contribution amount was taxable (that is, Edna had not made any nondeductible contributions to the traditional IRA).

In 2007, Edna made a $2,000 annual after-tax contribution to the same Roth account for the 2006 tax year. Since then, she has made no further Roth contributions.

Edna withdrew $15,000 in 2012. At the time of the withdrawal, the Roth account balance was $54,000.

Under the ordering rules for Roth withdrawals, the first $2,000 is treated as coming from Edna's annual after-tax contribution for the 2006 tax year (Layer No. 1). That amount can be taken out at any time with no federal income tax and no 10 percent penalty tax.

The remaining $13,000 is considered a partial withdrawal of the $30,000 taxable conversion contribution amount from 2005 (Layer No. 2). Because Layer No. 2 was taxed in 2005, the withdrawal is federal-income-tax-free. Because the withdrawal occurs after the end of Edna's 5-year period for worrying about the 10 percent penalty tax, (the 5-year clock started ticking on January 1, 2005), the $13,000 withdrawal is also free of the 10 percent penalty tax.

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[26] See IRC secs. 408A(d)(2) and 72(t) and Reg. 1.408A-6, Q&A-5.

Therefore, Edna owes no federal income tax and no 10 percent penalty tax on her $15,000 withdrawal. Great!

Key Point: Withdrawing conversion contribution money within 5 years of the beginning of the conversion year is a bad idea unless an IRA exception to the 10 percent penalty tax is available.

Example 3-11

Early Roth Withdrawals Can Be Hit With Both Income Tax and 10 Percent Penalty Tax

Use the same basic facts as in the preceding example, except that now Edna withdraws $35,000 in 2012. As before, her Roth IRA balance was $54,000 at the time of the withdrawal.

As in the preceding example, the first $2,000 is deemed to be a federal-income-tax-free and penalty-free withdrawal of Edna's annual after-tax contribution for the 2006 tax year (Layer No. 1).

The next $30,000 is deemed to come from the 2005 taxable conversion contribution (Layer No. 2). That $30,000 comes out federal-income-tax-free. It also comes out free of the 10 percent penalty tax because Edna's 5-year period expired before the withdrawal.

The final $3,000 comes from account earnings (Layer No. 4), because all of Edna's $32,000 of annual and conversion contributions have been withdrawn. The entire $3,000 from Layer No. 4 must be included in Edna's 2012 gross income because she is not age 59½, dead, disabled, or using the money for qualified home acquisition costs (see the following section). The entire $3,000 is also hit with the 10 percent penalty tax unless Edna qualifies for one of the IRA exceptions to the penalty tax, which she does not.

The $3,000 taxable amount should be reported on Line 15b of Edna's 2012 Form 1040, and the 10 percent penalty tax of $300 should be reported on the appropriate line on page 2 of her Form 1040. Edna's return should include completed Forms 8606 and 5329.

Scenario 2: Nonqualified Withdrawal Because Client Fails to Satisfy Five-Year Rule

Any Roth withdrawal taken before satisfying the five-year rule is also a *nonqualified withdrawal* by definition. There are no exceptions. As such, it is potentially, but not necessarily, subject to income tax and a 10 percent penalty tax. In this scenario, nonqualified withdrawals are generally handled under the same four-layer system discussed in the previous section.

> **Key Point:** If a client has several Roth IRAs, he or she must aggregate them (that is, add them together and treat them as a single account) to determine which layer(s) each withdrawal comes from and the resulting tax consequences.[27]

Most importantly, nonqualified withdrawals from Layer No. 4 (account earnings) are 100 percent taxable. Fill out Part III of Form 8606 to calculate the taxable amount from Layer No. 4, and enter that figure on Line 15b of Form 1040.

The big difference between Scenario 1 and Scenario 2 is that clients are never hit with the 10 percent premature withdrawal penalty tax on Scenario 2 withdrawals taken after reaching age 59½. If a client is younger, however, the penalty tax will take a bite out of Scenario 2

[27] See IRC sec. 408A(d)(4) and Reg. 1.408A-6, Q&A-8.

withdrawals unless he or she is eligible for an IRA exception to the penalty tax.[28] If he or she owes the penalty tax, fill out Form 5329 and enter the penalty tax on line 58 of Form 1040.

Tax Reporting for Nonqualified Withdrawals

When an account owner takes a nonqualified withdrawal, he or she should receive a Form 1099-R from the Roth IRA trustee. Box 1 of the Form 1099-R should report the gross amount of the nonqualified withdrawal. Usually, Box 2b will be checked to indicate that the trustee has declined to determine the taxable amount (if any). However, if the trustee knows the taxable amount, it could be reported in Box 2.

Box 7 of Form 1099-R should report distribution code T (exception applies) if the trustee knows the 10 percent penalty tax is not owed because the account owner was age 59½ or older, disabled, or dead when the nonqualified withdrawal was taken. Box 7 of Form 1099-R should also report distribution code J (early distribution) if the trustee thinks the 10 percent penalty tax might be owed.

According to the Form 1040 instructions, when a 2011 nonqualified withdrawal is reported with distribution code T in box 7 of Form 1099-R and the withdrawal is from a *pre-2007* conversion contribution, the total amount of the withdrawal should be reported on line 15a of Form 1040. Zero should be reported on line 15b, because the withdrawal is federal-income-tax-free. Presumably the same treatment applies to a nonqualified withdrawal of a pre-2007 conversion contribution when the trustee fails to enter code T in box 7 of Form 1099-R.

For other nonqualified withdrawals taken in 2011, the Form 1040 instructions seem to state that nothing should be reported on line 15a of Form 1040. Form 8606 should be completed to determine the taxable amount, if any, that is reported on line 15b of Form 1040. Regardless of what is reported on line 15a, the most important thing is to get the amount on line 15b right (that is, the taxable amount, if any).

Special First-Time Home Purchase Provision for Withdrawals Taken Before 59½

Assuming the Roth account owner has satisfied the five-year rule, a special provision allows federal-income-tax-free and penalty-free withdrawals to the extent of money spent by the account owner within 120 days to pay for qualified acquisition costs for a principal residence—even if the account owner is under age 59½. However, there is a $10,000 lifetime limit on this deal. To the extent this special provision applies to a withdrawal, the affected amount is effectively taxed the same as a qualified withdrawal.

The principal residence can be acquired by (1) the account owner or the account owner's spouse; (2) the account owner's child, grandchild, or grandparent; or (3) the spouse's child, grandchild, or grandparent. The buyer of the principal residence, and the spouse, if the buyer is married, must not have owned a present interest in a principal residence within the two-year period that ends on the acquisition date.

[28] See IRC sec. 72(t).

Qualified acquisition costs are defined as costs to acquire, construct, or reconstruct a principal residence, including closing costs.[29]

> **Key Point:** This special provision is only available when the account owner has satisfied the five-year rule.

Using Roth Conversions for Estate Planning

The "garden variety" reason for converting a traditional IRA into a Roth account is to accumulate earnings that can be withdrawn tax-free after age 59½ to help finance the client's retirement. But, if the client does not really need the money, there is another less-publicized advantage to converting. If the client wants to pass along as much as possible to her heirs, a Roth account can be a great estate planning vehicle. Roth IRA balances are not exempt from the federal estate tax, however, by paying the upfront conversion tax hit, the client is effectively prepaying her heirs' future income taxes and also reducing his or her taxable estate by the amount of the conversion tax hit. Doing this does not result in any gift tax or any utilization of the client's $5 million or $5.12 million unified federal gift and estate tax exemptions (for 2011 and 2012, respectively).

As mentioned earlier in this chapter, a big advantage of Roth accounts is they are *not* covered by the RMD rules that apply to traditional IRAs. The RMD rules force traditional IRA owners to begin dipping into their accounts each year after turning age 70½. Of course this means Uncle Sam gets his cut, and the state tax collector does as well. When the client does not need the IRA money, being forced to take RMDs and pay the resulting taxes is pretty darned frustrating. Converting a traditional IRA into a Roth account stops the RMD nonsense in its tracks. Now the client is free to leave the account balance untouched and accumulate as many tax-free dollars as possible to pass along to his or her heirs.

The RMD exemption ends when the Roth account owner (your client) dies. Now the Roth account falls under the same RMD rules as apply to inherited traditional IRAs (specifically the rules that apply when the account owner dies before the deadline for taking his or her first RMD). However, if the deceased account owner's heir is disciplined enough to take only RMDs from the inherited Roth account, it can keep on earning tax-free income for years (maybe many years), as the following example illustrates.

Example 3-12

Husband is age 65 when he converts his traditional IRA into a Roth account. He lives for 8 more years and never takes any withdrawals. Wife, age 70, inherits the Roth IRA because she is the sole designated beneficiary of the account. According to the life expectancy table found in Treasury Regulation 1.401(a)(9)-9, Q&A-1, Wife is expected to live another 17.0 years. Under the rules for inherited IRAs, she can treat the inherited Roth account as her own account, so she is not required to take any RMDs during her lifetime. In fact, she does not take out a dime.

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[29] See IRC sec. 408A(d)(5), and IRC sec. 72(t)(2)(F) and (t)(8).

At age 87, Wife dies and leaves the Roth IRA to Sonny Boy, who was designated as the new account beneficiary when Wife took over the Roth IRA.

Sonny Boy is 55. The IRS life expectancy table states that he should live for another 29.6 years. Granted, he must start taking RMDs and gradually liquidate the inherited Roth IRA over this period. But if Sonny Boy takes *only* the RMD amount for each year, he will preserve the account's tax-free earning power as long as possible.

In this example, the Roth IRA "lives" for a total of 54.6 years: 8 years with Husband, 17 years with Wife, and 29.6 years with Sonny Boy. That is pretty good mileage considering that Husband was a well-seasoned 65 years old when he set up the Roth account in the first place.

What really happened here? In effect, Husband and Wife used the Roth IRA tax rules to set up a long-term *tax-free annuity* for Sonny Boy.

Key Points: For this strategy to work as advertised, Husband should designate Wife as the Roth IRA beneficiary before he dies. Wife should then declare the account her own by retitling the Roth IRA in her own name and naming Sonny Boy as the new beneficiary. Finally, Sonny Boy must take his first RMD by December 31 of the year following the year of Wife's death. Otherwise, he will have to liquidate the account after only 5 years, which would end the tax-free income game prematurely.

In summary, the following assumptions make using a Roth IRA for estate planning a good idea:

- Congress will leave the current Roth IRA tax rules in place, at least for a good long while.
- The original Roth IRA owner must not need the Roth money to pay for his or her retirement.
- The account owner must believe that his or her heirs will keep their hands out of the inherited Roth IRA till, except to take annual RMDs.
- The Roth account can be invested at a respectable rate of return, which makes paying the up-front conversion tax a wise financial move.

Conclusion

Although the tax rules for nonqualified Roth withdrawals are complicated, everything falls in place when a client properly completes Part III of Form 8606. Remember that shortly after the end of any year a client takes Roth withdrawals, he or she should receive a Form 1099-R from the Roth trustee or custodian. It shows the total amount of withdrawals for the preceding year, and the IRS gets a copy. So if the client took any nonqualified withdrawals, the IRS will expect to see Form 8606 included with his or her return.

4

Maximizing Tax Benefits for Personal Residence Transactions

Introduction

Under the Internal Revenue Code (IRC) Section 121 home sale gain exclusion rules, married couples can exclude from federal income tax gains up to $500,000, and singles can exclude gains up to $250,000. The first part of this chapter covers the twists and turns necessary to wring the maximum tax savings out of the home sale gain exclusion rules which are still very helpful to many folks (particularly those who have owned their homes for a long time and thereby benefitted from substantial appreciation, despite significant downturns in values in most areas).

This chapter also covers the tax rules that can apply when a residence is sold in a short sale (that is, for less than the outstanding mortgage[s] against the property) or is foreclosed by the lender and concludes with a discussion of the confusing tax implications of converting a personal residence into a rental property and the homebuyer tax credit repayment rules.

Qualification Rules for Gain Exclusion Privilege

IRC Section 121 allows singles to exclude gains up to $250,000 and married couples filing jointly to exclude up to $500,000. The seller need not complete any special tax form to take advantage. As explained later in this chapter, sales that are wholly or partly taxable are reported on Schedule D. If the sale is partially taxable due to business or rental use, Form 4797 (Sales of Business Property) must also be completed to account for all or part of the gain and determine how much is subject to the 25 percent maximum rate on unrecaptured IRC Section 1250 gains.

Ownership and Use Tests

The primary limitation rule is that the property must have been

- *owned* as the seller's principal residence for at least two years out of the five-year period ending on the sale date and
- *used* as the seller's principal residence for at least two years out of the five-year period ending on the sale date.

What Is a Principal Residence?

The regulations state that all facts and circumstances must be evaluated to determine whether or not a property is the taxpayer's principal residence for gain exclusion purposes. When several residences are occupied during the same year, the general rule is that the principal residence for that particular year is the one where the majority of time is spent during that year. Other relevant factors can include, but are not limited to, the following:

- Where the taxpayer works
- Where family members live
- The address shown on income tax returns, driver's licenses, and auto registration and voter registration cards
- The mailing address for bills and correspondence
- Where bank accounts are maintained
- Where memberships and religious affiliations are maintained[1]

Example 4-1

Melynda, an unmarried individual, owns one home in New Jersey and another in Arizona. During 2007–11 (five years), she spends seven months each year in the New Jersey home and the remaining five months in the Arizona home. Melynda then sells both properties on January 1, 2012. Barring unusual circumstances, the New Jersey home is considered her principal residence, and she can claim the gain exclusion privilege only for that property.

Even though Melynda owned and used the Arizona home as a residence for an aggregate of 25 months during the 5-year period ending on the sale date, she cannot claim the gain exclusion privilege for that property because it was not her principal residence at any time during the 5-year period.[2] However, see example 4-2.

The regulations confirm it is possible for two residences to simultaneously pass the gain exclusion ownership and use tests, as illustrated by the following example.

[1] See Treas. Reg. 1.121-1(b)(2).

[2] Treas. Reg. 1.121-1(b)(4), example 1.

Example 4-2

Milton, an unmarried individual, owns one home in Vermont and another in Florida. During 2008 and 2009, he lives in the Vermont home. During 2010 and 2011, he lives in the Florida home. During 2012, he once again lives in the Vermont home. Under these facts, Milton would qualify for the gain exclusion privilege if *either* home is sold in 2012, because the two-out-of-five-years ownership and use tests would be passed for both homes. However, if both homes are sold in 2012, Milton cannot claim exclusions for both sales. That is prohibited by the anti-recycling rule explained later.[3]

The requirements to (1) *own* the property for at least 2 years during the 5-year period ending on the sale date, and (2) *use* the property as a principal residence for at least 2 years during the same 5-year period are completely independent. In other words, periods of ownership and use need not overlap. For this purpose, "2 years" means periods aggregating 24 months or 730 days.[4]

Example 4-3

Kirsten, a single individual, rents a condo and uses it as her principal residence for all of 2008 and 2009. On January 1, 2010, she purchases the condo and rents it out to others for all of 2010 and 2011. Early in 2012, Kirsten sells the property. Under these facts, Kirsten passes the two-out-five-years ownership and use tests, even though her periods of ownership and use are not concurrent.[5]

In determining whether the two-out-of-five-years use test is passed, only periods during which the property is actually occupied by the taxpayer generally count. However, short temporary absences (such as for vacations) also count as periods of use. This is true even when the property is rented out during those short absences.

Example 4-4

Kris, a single individual, purchases a home on January 1, 2010. He uses it as his principal residence for all of 2010 and 2011. However, he vacations away from the property for 2 months during both of those years. On February 1, 2012, Kris sells the home.

Under these facts, Kris passes both the ownership and use tests, even though his actual periods of occupancy aggregate to only 21 months (25 months minus 4 months away on vacation because short temporary absences count as periods of occupancy, and the regulations *specifically indicate that a 2-month vacation is a short temporary absence.*

So Kris is deemed to have used the property as his principal residence for 25 months during the 5-year period ending on the sale date. Kris is, therefore, entitled to a $250,000 gain exclusion.[6]

Variation

The results would be the same if Kris rented out his home during his vacation absences.[7]

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[3] See Treas. Reg. 1.121-1(b)(4), example 2.

[4] See Treas. Reg. 1.121-1(c)(1) and (2).

[5] See Treas. Reg. 1.121-1(c)(4), example 3.

[6] See Treas. Reg. 1.121-1(c)(4), example 5.

[7] Treas. Reg. 1.121-1(c)(2).

Gain Exclusion Rules for Married Couples

In order to qualify for the $500,000 joint return exclusion, (1) one or both spouses must pass the ownership test with respect to the property and (2) both spouses must pass the use test.[8] When only one spouse passes both tests, the maximum gain exclusion is generally only $250,000.[9] However, see the explanation later in this chapter of how the prorated (reduced) gain exclusion privilege can potentially apply to the spouse who fails to pass both tests.

Example 4-5

Fritz and Stella are married after a whirlwind romance that began on a cruise ship. Immediately following the marriage, Fritz sells his valuable home for a $600,000 gain. Fritz had owned and used the home as his principal residence for many years before he met Stella. The couple files a joint return for the year of sale. Unfortunately, they do not qualify for the $500,000 joint return exclusion, because Stella does not pass the use test with respect to the property. Therefore, Fritz and Stella must report a whopping $350,000 taxable gain on their joint return ($600,000 – $250,000).[10]

Strategy: Instead of selling immediately, the couple should live together in Fritz's home for at least 2 years after their marriage. That way, they will qualify for the full $500,000 joint return exclusion (Fritz will pass the ownership test, and both Fritz and Stella will pass the use test).

When a joint return is filed, it is also possible for the spouses to individually pass the ownership and use tests for 2 separate residences. In such case, a separate $250,000 exclusion is potentially available to each spouse.[11] Each spouse's eligibility for the $250,000 exclusion is determined separately, as if the couple were unmarried. For this purpose, however, a spouse is considered to individually own a property for any period the property is actually owned by *either* spouse.[12]

Example 4-6

Wilma and Fred have a "commuter marriage." Wilma works in San Francisco and lives most of the time in the couple's condo there. Fred works in Baltimore and lives in the couple's townhouse there. On some weekends, one spouse flies to the other's city, and they both stay in their abode in that location. Under these facts, the $500,000 joint return exclusion is *not* available for either home because *both* spouses must pass the use test in order for a residence to qualify for the larger exclusion.

However, separate $250,000 exclusions are potentially available for each residence. Both homes have been owned jointly by the couple for 5 years, and Wilma passes the use test for the San Francisco home, while Fred passes the use test for the Baltimore home.

Under these facts, Wilma would qualify for a $250,000 exclusion if the San Francisco home is sold, while Fred would qualify for a separate $250,000 exclusion if the Baltimore home is sold.[13] Because each spouse's eligibility for a $250,000 exclusion is determined separately, the San Francisco and Baltimore

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8 Internal Revenue Code (IRC) sec. 121(b)(2)(A).

9 Treas. Reg. 1.121-2(a)(3)(ii).

10 See Treas. Reg. 1.121-2(a)(4), example 4.

11 IRC sec. 121(d)(1).

12 See Treas. Reg. 1.121-2(a)(3)(ii).

13 See Treas. Reg. 1.121-2(a)(4), examples 3 and 4.

homes could be sold within 2 years of each other (or even in the same year) without violating the anti-recycling rule explained later in this chapter. In other words, two separate $250,000 exclusions could be claimed in Wilma and Fred's joint return, even if the two sales are close together in time.

Variation

The results would be the same even if Fred separately owns the San Francisco home and Wilma separately owns the Baltimore home because, under the joint return rules, Wilma is considered to own any home actually owned by Fred, and Fred is considered to own any home actually owned by Wilma.[14] That means Wilma would still pass the ownership and use tests for the San Francisco home, and Fred would still pass the ownership and use tests for the Baltimore home.

Special Exception for Unmarried Surviving Spouses May Permit Larger $500,000 Gain Exclusion

An unmarried individual can potentially exclude from federal income taxation up to $250,000 of gain from selling a principal residence under IRC Section 121. Married joint filers can potentially exclude up to $500,000. However, if your client is a surviving spouse, he or she is not allowed to file a joint return for years after the year in which the spouse dies (unless your client remarries). Before legislation enacted in 2007 fixed this problem, an unmarried surviving spouse could not take advantage of the larger $500,000 home sale gain exclusion if he or she sold a principal residence in a year after the year when the spouse died. Instead, the surviving spouse was limited to the smaller $250,000 exclusion.

Thankfully, the 2007 legislation corrected this unfair situation. Therefore, an unmarried surviving spouse can now claim the larger $500,000 gain exclusion for a principal residence sale that occurs within 2 years after the spouse's death, assuming all the other requirements for the $500,000 exclusion were met immediately before that person died.[15]

> **Key Point:** The 2-year eligibility period for the larger exclusion begins on the date of the deceased spouse's death. Therefore, a sale that occurs in the second calendar year following the year of death but more than 24 months after the deceased spouse's date of death will not qualify for the larger $500,000 gain exclusion.

Anti-Recycling Rule

As mentioned earlier in this chapter, the other big qualification rule for the home sale gain exclusion is that the exclusion is generally available only when the taxpayer has *not* excluded an earlier gain within the two-year period ending on the date of the later sale.[16] In other words, the gain exclusion privilege generally cannot be "recycled" until two years have passed since it was last used.

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[14] Treas. Reg. 1.121-2(a)(3)(ii)

[15] See IRC sec. 121(b)(4), as amended.

[16] IRC sec. 121(b)(3).

The $500,000 joint return exclusion is only available when *neither* spouse excluded a gain from an earlier sale within the 2-year period.[17] If one spouse did, and the other did not, the gain exclusion is generally limited to $250,000.

All the discussion earlier in this section assumes the anti-recycling rule is met. If the rule is *violated*, the taxpayer is ineligible to claim a gain exclusion unless

1. a prorated (reduced) gain exclusion is available or
2. the taxpayer "elects out" of the gain exclusion privilege for the earlier sale.

Rules for both of these situations are explained later in this chapter.

Example 4-7

Murph, a single individual, sold his original principal residence on July 1, 2010, and excluded the gain. Before selling that home, Murph purchased another property and began using it as his new principal residence on January 1, 2010 (six months earlier). Murph then decides to sell the latest home on March 1, 2012, thinking he will qualify for the gain exclusion break on that sale too.

Wrong! Although Murph passes the two-out-of-five-years ownership and use tests with flying colors, he violates the anti-recycling rule. Therefore, Murph is ineligible to exclude any gain from his 2012 sale, *unless* one of the two circumstances listed previously applies.[18]

Prorated (Reduced) Gain Exclusion Loophole for "Premature" Sales

What happens when a taxpayer fails to meet the basic gain exclusion timing requirements? For example, he or she might sell his or her home for a healthy profit after living there for only 18 months instead of the required 2 years. Or he or she might sell her current home less than 2 years after excluding gain from the sale of a previous residence. Must the client pay tax on the entire gain when he or she makes such a "premature" sale? Not necessarily. Under the regulations, taxpayers can often avoid any federal tax by claiming a prorated (reduced) gain exclusion (a fraction of the $250,000 or $500,000 amount that would ordinarily apply). However, when the seller is ineligible for this prorated exclusion loophole, the entire profit is taxed. Fortunately, the regulations make it pretty easy to qualify for the prorated gain exclusion, as discussed subsequently.

Assuming the seller *is* eligible (as defined subsequently), the prorated gain exclusion amount equals the full $250,000 or $500,000 figure (whichever would otherwise apply) multiplied by a fraction. The numerator is the shorter of (1) the aggregate period of time the property is owned and used as the principal residence during the 5-year period ending on the sale date or (2) the period between the last sale for which an exclusion was claimed and the sale date for the home currently being sold. The denominator is 2 years, or the equivalent in months or days.[19]

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[17] IRC sec. 121(b)(2)(A)(iii).

[18] See Treas. Reg. 1.121-2(b).

[19] See IRC sec. 121(c)(1) and Treas. Reg. 1.121-3(g).

Example 4-8

Chuck and Donna are married and file jointly. They owned and used a home as their principal residence for 11 months. Chuck and Donna are entitled to a prorated gain exclusion of $229,167 on their joint return ($500,000 × 11/24). That should be more than enough to avoid any federal tax hit from prematurely selling their home.

Example 4-9

Draco is unmarried. He sold his previous home 15 months ago and excluded the gain. Now, he is about to sell his current home, which he has owned and used as his principal residence for 21 months. He bought the current property and occupied it for 6 months before selling the previous home. Draco is entitled to a prorated gain exclusion of $156,250 ($250,000 × 15/24). That should be more than enough to avoid any federal tax bill from prematurely selling his current home. (The gain exclusion that Draco claimed on the sale of his previous home is completely unaffected by all this.)

When the seller qualifies for the prorated exclusion, it will almost certainly be big enough to shelter the entire gain from making a premature sale. However, the prorated exclusion loophole is only available when the premature sale is primarily due to

- a change of place of employment,
- health reasons, or
- unforeseen circumstances.

Premature Sale Due to Employment Change

Under the regulations, a taxpayer is eligible for the prorated gain exclusion privilege whenever a premature home sale is primarily due to a change in place of employment for any qualified individual. *Qualified individual* means the taxpayer, his or her spouse, any co-owner of the home, or any other person whose main residence is within the taxpayer's household.[20]

A premature sale will *automatically* be considered primarily due to a change in place of employment if any qualified individual passes the following distance test: the new place of employment or self-employment must be at least 50 miles farther away from the former residence (the property that is being sold) than was the former place of employment or self-employment from the former residence.

Example 4-10

Susan runs her sole proprietorship business exclusively out of her home. She decides to sell the home, which she has owned and used as her principal residence for only 19 months. Susan then buys a new home 65 miles away. She again runs her business exclusively out of the new home.

Under these facts, Susan passes the 50-mile test because her new place of self-employment (the new house) is 65 miles farther away from her former home than was her old place of self-employment (the old house which was, obviously, 0 miles away from itself).

[20] See Treas. Reg. 1.121-3(c).

Therefore, Susan automatically qualifies for the prorated gain exclusion. If she is married, the prorated exclusion is $395,833 ($500,000 × 19/24). If she is single, the prorated exclusion is $197,917 ($250,000 × 19/24). Susan will almost certainly be able to avoid any federal tax bill from prematurely selling her home except that she *will* be taxed on any gain attributable to depreciation from post-5/6/97 business or rental usage of her home, as explained later in this chapter.

Example 4-11

Use the same basic facts as in example 4-10, except that now Susan's husband was the self-employed person who worked out of the home. Because he is a qualified individual who passes the 50-mile test, Susan automatically qualifies for the prorated gain exclusion privilege on her joint return. The prorated exclusion amount is $395,833 ($500,000 × 19/24).

When no qualified individual passes the 50-mile test, a taxpayer is still eligible for the prorated gain exclusion break if the facts and circumstances show his or her premature home sale was primarily due to a qualified individual's change in place of employment.

Example 4-12

Dante is married and files jointly with his wife, Clara. She is an emergency room physician. Because Clara must live close to the hospital where she works, the couple's home is only 3 miles away.

Clara then becomes employed by a different hospital. As a result, the home is sold. However, it was owned and used as the principal residence for only 22 months. Dante and Clara then rent a townhouse that is only 5 miles away from her new job location; her new job is 42 miles away from the old residence.

Dante and Clara fail the 50-mile test, because Clara's new job is only 39 miles farther away from the old home than was her old job (42 miles versus 3 miles). However, due to the nature of Clara's work, she must live close to her place of employment. In this case, the facts and circumstances clearly show the premature sale of the former home was primarily due to a change in the place of Clara's employment.

Therefore, Dante and Clara are eligible for the prorated gain exclusion privilege on their joint return. The prorated exclusion amount is $458,333 ($500,000 × 22/24).[21]

> **Key Point:** When the 50-mile test cannot be passed, obtain documentation showing the premature home sale was, nevertheless, primarily due to a qualified individual's change in place of employment (assuming the facts so indicate). That should preserve the client's eligibility for the prorated gain exclusion loophole.

Premature Sale Due to Health Reasons

Under the regulations, the home seller is also eligible for the prorated gain exclusion privilege whenever a premature sale is primarily due to health reasons. This test is passed whenever the seller must move in order to

- obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual or
- obtain or provide medical or personal care for a qualified individual who suffers from a disease, illness, or injury.

[21] See Treas. Reg. 1.121-3(c)(4), example 4.

For this purpose, *qualified individual* means (1) the taxpayer, (2) his or her spouse, (3) any co-owner of the home, or (4) any person whose principal residence is within the taxpayer's household. Almost any close relative of a person listed as (1)–(4) also counts as a qualified individual, as does any descendent of the taxpayer's grandparent (such as a first cousin).[22]

A premature sale will *automatically* be considered primarily for health reasons whenever a doctor recommends a change of residence for reasons of a qualified individual's health (meaning to obtain, provide, or facilitate, as explained previously). Otherwise, the facts and circumstances must indicate that the premature sale was primarily for reasons of a qualified individual's health.

The prorated gain exclusion *cannot* be claimed for a premature sale that is merely beneficial to the general health or well-being of a qualified individual.[23]

> **Key Point:** Whenever possible, a seller should obtain a doctor's recommendation in writing to prove the seller is entitled to the prorated gain exclusion, because the premature sale was primarily for reasons of a qualified individual's health. The doctor's note should be kept with the seller's tax records.

Premature Sale Due to Other Unforeseen Circumstances

Treasury Regulation 1.121-3(e) provides that, in general, a premature sale is by reason of unforeseen circumstances if the primary reason for the sale is the occurrence of an event that the taxpayer could not have reasonably anticipated before purchasing and occupying the residence.

However, a premature sale that is primarily due to a preference for a difference residence or an improvement in financial circumstances will not be considered to be by reason of unforeseen circumstances unless the safe-harbor rule explained in this section applies.[24]

Under a regulatory safe-harbor rule, a premature sale will automatically be deemed to be by reason of unforeseen circumstances if any of the following events occur during the taxpayer's ownership and use of the property as the taxpayer's principal residence:

- Involuntary conversion of the residence
- A natural or manmade disaster or acts of war or terrorism resulting in a casualty to the residence
- Death of a qualified individual
- A qualified individual's cessation of employment making him or her eligible for unemployment compensation
- A qualified individual's change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household
- A qualified individual's divorce or legal separation under a decree of divorce or separate maintenance
- Multiple births resulting from a single pregnancy of a qualified individual

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[22] See Treas. Reg. 1.121-3(f)(1)–(5).

[23] See Treas. Reg. 1.121-3(d).

[24] See Treas. Reg. 1.121-3(e)(1) and (e)(4), examples 7, 8, and 10.

For purposes of this safe-harbor rule, a *qualifying individual* is defined by Treasury Regulation 1.121-3(f) as (1) the taxpayer, (2) taxpayer's spouse, (3) a co-owner of the residence in question, or (4) a person whose principal place of abode is in the same household as the taxpayer.

> **Key Point:** When none of the preceding safe-harbor events occur, a taxpayer can still qualify for the reduced gain exclusion privilege if the facts and circumstances indicate the primary reason for the premature home sale was the occurrence of an event that the taxpayer could not have reasonably anticipated before purchasing and occupying the residence. The regulations include three examples of non-safe-harbor situations that seem to indicate the IRS will be fairly liberal in this area.[25]

> **Key Point:** The IRS can also designate other events as unforeseen circumstances in published guidance of general applicability (such as revenue rulings) or in rulings addressed to specific taxpayers (such as private letter rulings). In the latter case, however, the guidance applies only to the specific taxpayers to whom the guidance is directed.[26]

Premature Sales in Other Situations

As explained earlier in this chapter, when the taxpayer's premature sale *does not* qualify for any of the regulatory safe-harbor rules explained previously, the reduced gain exclusion break can still be claimed if the taxpayer can establish, based on facts and circumstances, that the *primary reason* for the premature sale was one of the three statutory circumstances.[27]

Factors that may be relevant in determining the primary reason for a premature sale include, but are not limited to, the following:[28]

- Whether the premature sale and the circumstances giving rise to the sale are proximate in time
- A material change in the suitability of the property as the taxpayer's principal residence
- A material change in the taxpayer's financial ability to maintain the property
- Whether the taxpayer actually uses the property as a residence during the taxpayer's ownership period
- Whether the circumstances giving rise to the premature sale were reasonably foreseeable when the taxpayer began using the property as a principal residence
- Whether the circumstances giving rise to the premature sale actually occurred during the period when the taxpayer owned and used the property as a principal residence

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[25] See Treas. Reg. 1.121-3(e)(4), examples 4, 6, and 9.

[26] See Treas. Reg. 1.121-3(e)(3).

[27] Treas. Reg. 1.121-3(b).

[28] *Ibid.*

Claiming Exclusion for Home Used Partly for Business or Rental

Consider a taxpayer who uses his or her entire basement as a deductible home office during the entire time he or she owns the home. Before the IRC Section 121 regulations were issued, when selling the house, the IRS would have required the taxpayer to treat the sale as two separate transactions, allocating the tax basis and sales proceeds between the business part of the property (the basement) and the residential part (the rest of the home). The profit on the residential part would generally qualify for the gain exclusion, while the profit on the business part would not, because it was not used for residential purposes for at least two years during the five-year period ending on the sale date.

Therefore, any profit allocable to the business portion of the taxpayer's property would be taxed. Before the regulations, the results would have been the same if the taxpayer rented out his or her basement instead of using it as a deductible home office. Naturally, this discouraged people from claiming legitimate home office deductions and from renting out excess space for increased cash flow.

Thankfully, the regulations deliver a much better answer in these circumstances because the taxpayers can now treat their entire homes as a single property, provided the residential part and the business or rental part are both within the same dwelling unit.[29] In other words, the *entire* property will qualify for the full $250,000 or $500,000 gain exclusion (whichever applies), as long as the basic gain exclusion timing requirements are met for the residential part.

Naturally, there is an exception, but it is easy to live with. The seller must include in his or her taxable income any gain up to the amount of depreciation deductions claimed for post-5/6/97 business or rental usage of the property.[30] Such a gain will generally qualify as unrecaptured IRC Section 1250 gain subject to a maximum federal tax rate of 25 percent.[31] Of course, the seller has already reaped tax savings from those depreciation writeoffs, so this rule is more than fair.

> **Key Point:** The regulations basically remove any objection to claiming the home office deduction, as long as the office space is in the same dwelling unit as the residential space.

Example 4-13

April uses part of her home as a deductible office for her real estate sales business during her entire ownership period. As a result, she claims $10,000 worth of depreciation for post-5/6/97, usage of the office space. Now she sells for a $125,000 profit (including $10,000 attributable to the depreciation writeoffs).

[29] Treas. Reg. 1.121-1(e).

[30] Treas. Reg. 1.121-1(d) and (3).

[31] IRC sec. 1(h)(1)(D) and 1(h)(7).

Assuming April meets the basic gain exclusion timing requirements for the residential part of her property, she can exclude $115,000 of gain ($125,000 – $10,000). The $10,000 taxable amount is unrecaptured IRC Section 1250 gain subject to a maximum federal rate of only 25 percent.[32]

Example 4-14

Use the same basic facts as in the previous example, except that now April's office is in a detached building formerly used as a garage. April must treat the sale of her property as two separate sales. She must allocate her tax basis and sales proceeds between the detached building and the rest of the property and calculate two separate gains. She cannot exclude the gain from selling the detached building.

However, gain from the rest of the property—the part used as April's principal residence—is eligible for the full gain exclusion privilege ($250,000 or $500,000, depending on her circumstances), assuming she meets the basic gain exclusion timing requirements for that part.[33]

Example 4-15

Wilfred converted the basement of his home into a separate rental dwelling unit by installing kitchen and bathroom facilities and a separate entrance. When he sells the property, he must treat the sale as two separate transactions. He must allocate tax basis and sales proceeds between the basement and the rest of the property and calculate two separate gains. Wilfred cannot exclude the gain from selling the basement.

However, gain from the rest of the property—the part used as his principal residence— is eligible for the full gain exclusion privilege ($250,000 or $500,000, depending on Wilfred's circumstances), assuming he meets the basic gain exclusion timing requirements for that part.[34]

As the preceding two examples illustrate, the client should be careful about business or rental usage of space that is *not* within the same dwelling unit as the principal residence. Such use could trigger a taxable gain that cannot be sheltered by the gain exclusion privilege.

Specifically, when the amount of gain allocable to the separate space would be considerable, the client may want to avoid any business or rental usage during the two-year period preceding the sale date. That way, he or she will pass the two-out-of-five years use test for the business or rental part of the property, and it will be eligible for the gain exclusion privilege. Of course, the client's decision will depend on the amount of home office deductions or rental income that would be foregone in relation to the amount of taxable gain that would be avoided.

Premature Sale of Property Used for Business or Rental

When a taxpayer qualifies for the prorated gain exclusion privilege upon a premature sale of a residence used partly for business or rental purposes he or she computes his or her prorated gain exclusion amount as explained earlier in this chapter. Next, the seller uses the prorated

[32] See Treas. Reg. 1.121-1(e)(4), example 5.

[33] See Treas. Reg. 1.121-1(e)(4), examples 1 and 3.

[34] See Treas. Reg. 1.121-1(e)(4), examples 1 and 3.

exclusion to shelter otherwise taxable gain, as explained in the section "Claiming Exclusion for Home Used Partly for Business or Rental" in this chapter. When using the prorated exclusion, keep the following three caveats in mind:

1. The prorated exclusion privilege is *only* available for sales that are primarily (*a*) due to a change in a qualified individual's place of employment, (*b*) for reasons of a qualified individual's health, or (*c*) due to unforeseen circumstances.
2. The prorated exclusion *cannot* be used to shelter gain up to the amount of depreciation claimed for any post-5/6/97 business or rental use of the property.
3. When the business or rental part of the property is *not* in the same dwelling unit as the principal residence, the prorated exclusion can only be used to shelter gain allocable to the residential part of the property. Any profit on the business or rental part will be fully taxable.

Example 4-16

May, a single individual, uses part of her home as a deductible office for her real estate sales business during her entire ownership period. As a result, she claims $2,000 worth of depreciation for post-5/6/97, usage of the office space. For purposes of this example, the office is *not* in a separate structure. After owning the home for only 18 months, May sells for a $20,000 gain (including $2,000 attributable to depreciation). May's premature sale is primarily for reasons of a qualified individual's health.

Under these facts, May is entitled to a prorated exclusion of $187,500 ($250,000 × 18/24). She can therefore exclude her entire gain, except for the $2,000 attributable to post-5/6/97 depreciation. The $2,000 taxable amount is unrecaptured IRC Section 1250 gain subject to a maximum federal rate of only 25 percent.[35]

Example 4-17

Use the same basic facts as in the previous example, except that now May's deductible office is in a detached building formerly used as a garage. In this example, May must treat the sale of her property as two separate sales. She must allocate her tax basis and sales proceeds between the detached building and the rest of the property and calculate two separate gains.

May cannot exclude the gain from selling the detached building. However, gain from the rest of the property—the part used as her principal residence—can be sheltered by May's prorated exclusion amount ($187,500, as calculated in example 4-16).[36]

Example 4-18

Zed files jointly with his wife Nona. The couple converted the basement of their home into a separate rental dwelling unit by installing kitchen and bathroom facilities and a separate entrance. After owning the property for only 16 months, Zed and Nona are forced to sell because Nona's job is transferred to a distant city. Zed and Nona must treat their sale as two separate transactions. They must allocate tax basis and sales proceeds between the basement and the rest of the property and calculate two separate gains.

[35] See Treas. Reg. 1.121-1(e)(4), example 5 in conjunction with Treas. Reg. 1.121-3.

[36] See Treas. Reg. 1.121-1(e)(4), examples 1 and 3 in conjunction with Treas. Reg. 1.121-3.

They cannot exclude the gain from selling the basement. However, gain from the rest of the property—the part used as their principal residence—can be sheltered by their prorated gain exclusion amount of $333,333 ($500,000 × 16/24).[37]

Excluding Gains From Sale of Land Next to Residence

The IRC Section 121 regulations also allow taxpayers to use the gain exclusion break to shelter profit from selling vacant land next to the principal residence. In fact, the taxpayer can even sell the parcel with the home and the surrounding vacant land in completely separate transactions. Naturally, there are some ground rules:

- The vacant land must be sold within two years before or after the sale of the parcel containing the house. (Separate sales of the parcel containing the house and the adjacent vacant land within this four-year window *will not* be considered to violate the anti-recycling rule.)
- The sale of the parcel containing the house must itself qualify for the gain exclusion.
- The vacant land must be adjacent to the parcel containing the house.
- The vacant land must have been owned and used as part of the taxpayer's principal residence, and the two-out-of-five-years ownership and use tests must be passed for the vacant land.

When all these tests are passed, the seller can use his or her gain exclusion privilege to avoid any federal tax on up to $250,000—or $500,000 for a joint filer—of combined profits from selling the parcel containing the house and the adjacent vacant land.[38]

For instance, an example in the regulations states that a taxpayer can sell a one-acre parcel with his or her home in one transaction and a 29-acre adjacent parcel of vacant land in a separate transaction and use his or her gain exclusion to shelter the combined profits from the two sales. Presumably, the same favorable result would apply if the vacant land is sold in several separate transactions.

When the adjacent vacant land is sold in advance of the parcel containing the house, if the parcel with the house is not sold until after the due date of the return for the year of the land sale, the seller must report the land sale gain on his or her return for that year. Then, after the parcel containing the residence is sold, the seller can file an amended return to exclude the earlier land sale gain. The seller generally has three years from the date the original return for the year of the land sale is filed to file an amended return assuming the original return was filed on time.[39]

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[37] *Ibid*.

[38] See Treas. Reg. 1.121-1(b)(3).

[39] See IRC secs. 6511 and 6513.

Excluding Gains in Marriage and Divorce Situations

Home sales will often occur in both marriage and divorce situations. Of course, the IRC Section 121 home sale gain exclusion break can come in very handy when an appreciated principal residence is put on the block.

Sale After Marriage

It is possible for each spouse to individually pass the ownership and use tests for their respective residences. This is applicable in situations when a couple gets married and both spouses own separate residences from their single days. When the couple files jointly, each spouse can then claim a separate $250,000 exclusion on the couple's joint return.[40] Put another way, each spouse's eligibility for a separate $250,000 exclusion is determined independently, as if the couple were still unmarried.[41]

Example 4-19

Jack and Julie get married and decide to move into Jack's home. Neither party had lived in the other's home before the marriage. Immediately after the marriage, Julie sells her home. The couple can exclude up to $250,000 of gain from that sale on their joint return, provided Julie (1) owned and used the property as her principal residence for at least 2 years out of the 5-year period ending on the sale date and (2) did not exclude gain from any earlier sale within the preceding 2 years.

The couple may also decide to sell Jack' home. Once again, up to $250,000 of gain can also be excluded on the couple's joint return, assuming Jack meets the same requirements. It does not matter if the sale of Jack's home occurs within 2 years of the sale of Julie's home.

Variation

If the sale of Jack's home would trigger a $450,000 gain, Jack and Julie should (1) live together in Jack's home for at least 2 years and (2) make sure at least 2 years have elapsed since the sale of Julie's property. Then, the couple can sell Jack's home and claim the full $500,000 joint return exclusion.[42]

Sale Before Divorce

A soon-to-be divorced couple can shelter up to $500,000 of home sale profit in two different ways when they sell their principle residence while they are still legally married as of the end of the year:

1. The couple could file a *joint return* for the year of sale. Assuming they meet the basic home sale gain exclusion timing requirements, they can claim the maximum $500,000 exclusion on their joint return.
2. The couple could file *separate returns* for the year of sale, using married filing separate status. Assuming the home is owned jointly or as community property, each spouse can

[40] IRC sec. 121(d)(1).

[41] See Treas. Reg. 1.121-2(a)(3)(ii).

[42] See Treas. Reg. 1.121-2(a)(4), example 3.

then exclude up to $250,000 of his or her share of the gain on his or her separate return. To qualify for two separate $250,000 exclusions, each spouse must have (*a*) owned his or her part of the property for at least 2 years during the 5-year period ending on the sale date and (*b*) used the home as his or her principal residence for at least 2 years during that 5-year period.[43]

> **Key Point:** In most cases, the preceding favorable rules will allow the splitting couple to convert their home equity into tax-free cash. They can generally divide up that cash any way they choose without any further federal tax consequences and go their separate ways.[44]

Sale in Year of Divorce or Later

When a couple is divorced as of the end of the year in which their principal residence is sold, they are considered divorced for that entire year. Therefore, they will be unable to file jointly for the year of sale. The same is true, of course, when the sale occurs *after* the year of divorce. Consider a situation in which ex-spouse A winds up with sole ownership of the residence, which was formerly owned solely by ex-spouse B, in a tax-free divorce-related transfer (under IRC Section 1041[a]). Under these facts, A is allowed to count B's period of ownership for purposes of passing the 2-out-of-5-years ownership test when A eventually sells the property.[45] A's maximum gain exclusion will be $250,000, because A is now single. However, if A *remarries* and lives in the home with the new spouse for at least 2 years before selling, A can qualify for the larger $500,000 joint return exclusion.

However, if ex-spouse A winds up owning some percentage of the home while ex-spouse B winds up owning the rest, when the home is later sold, both A and B can exclude $250,000 of their respective shares of the gain, provided each person (1) *owned* his or her part of the home for at least 2 years during the 5-year period ending on the sale date and (2) *used* the home as his or her principal residence for at least 2 years during that same 5-year period.[46]

> **Key Point:** Under the preceding rules, both ex-spouses will typically qualify for separate $250,000 exclusions when the home is sold soon after the divorce. However, when the property remains unsold for some time, the ex-spouse who no longer resides there will eventually fail the 2-out-of-5-years use test and become ineligible for the gain exclusion privilege.

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[43] See IRC sec. 121(a) and (b) and Treas. Reg. 1.121-2(a).

[44] IRC sec. 1041(a).

[45] IRC sec. 121(d)(3) and Treas. Reg. 1.121-4(b)(1).

[46] See IRC sec. 121(a) and (b)(1).

When "Nonresident Ex" Continues to Own Home Long After Divorce

In many cases, the ex-spouses will continue to co-own the former marital abode for a lengthy period after the divorce. Obviously, however, only one ex-spouse will continue to live in the home. After three years of being out of the house, the "nonresident ex" will fail the two-out-of-five-years use test. That means when the home is finally sold, the nonresident ex's share of the gain will be fully taxable. This is not good when your client is the non-resident ex. However, this undesirable outcome can be easily prevented with some advance planning.

Specifically, your client's divorce papers should stipulate that, *as a condition of the divorce agreement,* the client's ex-spouse is allowed to continue to occupy the home for as long as he or she wants, until the kids reach a certain age, for a specified number of years, or whatever the divorcing couple can agree on. At that point, the home can either be put up for sale with the proceeds split per the divorce agreement, or one ex-spouse can buy out the other's share for its current fair market value at that time.

This arrangement allows the nonresident ex (your client in our scenario) to receive "credit" for the other party's continued use of the property as that person's principal residence. When the home is finally sold, the nonresident ex will still pass the 2-out-of-5-years use test and thereby qualify for the $250,000 gain exclusion privilege.[47]

The same strategy works when your client is the nonresident ex and he or she winds up with *complete* ownership of the home, while the client's ex-spouse continues to live there. Making the ex-spouse's continued residence in the home a condition of the divorce agreement ensures that your client (the nonresident ex) will still qualify for the $250,000 gain exclusion when the home is eventually sold.

Example 4-20

Doug and Anne are divorced in September 2010. Each party retains 50 percent ownership of the former marital abode. As a specific condition of the divorce agreement, the decree stipulates that Anne is allowed to continue to reside in the home for up to 6 years (until the youngest child reaches age 18). Then Anne must either buy out Doug's 50 percent interest (based on market value at that time) or cooperate in selling the home.

Their property is indeed sold 6 years after the divorce. With respect to his 50 percent interest, Doug still passes the 2-out-of-5-years ownership and use tests even though he has not lived in the home for 6 years because he made sure the divorce decree included the magic words (the provision specifically permitting Anne to continue to reside in the home as a condition of the divorce settlement). Therefore, Doug is allowed to count Anne's continued use of the property as her principal residence as continued use by him. That means Doug qualifies for the $250,000 gain exclusion privilege, which he can use to shelter his share of the home sale profit.

Of course, Anne also passes the ownership and use tests, therefore, she also qualifies for a separate $250,000 exclusion, assuming she remains single.

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[47] See Treas. Reg. 1.121-4(b)(2).

Variation

Anne remarries. She and her new husband live in the home for at least 2 years before the sale date. With respect to her share of the gain, Anne can qualify for a $500,000 exclusion by filing a joint return with her new husband for the year of sale. With respect to his share of the gain, Doug still qualifies for a $250,000 exclusion, as explained previously.

Key Point: If Doug's attorney fails to include the magic words in the divorce decree, Doug will be taxed on his share of the home sale gain.

Example 4-21

Use the same basic facts as the previous example, except that now Doug has 100 percent ownership of the former marital abode after the divorce. As a specific condition of the divorce agreement, the decree stipulates that Anne is permitted to continue to reside in the home for up to 6 years. After that, Doug can sell the home at any time by giving Anne 3 months' notice of his intent to sell.

The property is indeed sold 6 years and 3 months after the divorce. Under these facts, Doug still passes the 2-out-of-5-years ownership and use tests even though he has not lived in the home for more than 6 years. So Doug qualifies for the $250,000 gain exclusion privilege, which he can use to shelter his home sale profit.

Key Point: If Doug's attorney fails to include the magic words in the decree, Doug will be taxed on his entire home sale gain.

"Electing Out" of Gain Exclusion Privilege

The home seller always has the option of "electing out" of the gain exclusion rules and reporting the home sale profit as a taxable gain.[48] The "election out" is made by reporting an otherwise excludable gain in the year-of-sale return. No further action is required.[49] In addition, the seller can *retroactively* make an "election out" or revoke an earlier "election out" by filing an amended return at any time within the three-year period beginning with the filing deadline for the year-of-sale return without regard to extensions.[50]

An obvious circumstance in which the "election out" can really pay off is when the taxpayer makes two principal residence sales within a two-year period, with the second sale producing a larger gain.

Example 4-22

Claudia, a single individual, owns a home in Dallas and another in Beaver Creek, Colorado. She used the Beaver Creek property as her principal residence in 2008 and 2009, and she used the Dallas home as her principal residence in 2010 and 2011. On January 1, 2012, Claudia sells the Dallas property for a $50,000 gain and moves into a new home in Austin, Texas. On July 15, 2012, Claudia sells the Beaver Creek home for a $250,000 gain.

[48] IRC sec. 121(f).

[49] See Treas. Reg. 1.121-4(g).

[50] See Treas. Reg. 1.121-4(g).

She meets the two-out-of-five-years ownership and use tests for both properties. However, the Beaver Creek property is sold less than two years after the Dallas sale. If Claudia claims the gain exclusion privilege for the Dallas sale, she will be prohibited from claiming an exclusion for the Beaver Creek sale (because that would violate the anti-recycling rule explained previously).

Under these facts, Claudia should "elect out" of the gain exclusion privilege for the Dallas sale. She can then exclude the entire $250,000 gain from the Beaver Creek sale.

Key Point: The "election out" is made by simply reporting the $50,000 profit from the Dallas sale on Claudia's 2012 Schedule D.

Understanding the Tax Implications of Personal Residence Short Sales and Foreclosures

You may have some clients who borrowed heavily to buy in at the top of the local real estate market. Or you may have some clients who overindulged on home equity loans while prices were still increasing. In either case, a client can wind up with mortgage debt in excess of the current value of his or her home. That is bad enough. But if he has to sell, he might face income taxes too.

Short Sales Involving Recourse Debt

Real estate professionals call a sale in which the mortgage debt exceeds the net sale price (after subtracting commissions and other costs) a *short sale*. The easiest way to explain the tax implications of a personal residence short sale is with some examples.

Example 4-23

Frances paid $190,000 for a residence that she could currently sell for $250,000. However, the first and second recourse mortgages against the property total $280,000. If Frances sells, she will have a taxable gain of $60,000 because the sale price exceeds the property's tax basis ($250,000 sale price – $190,000 basis = $60,000 gain). Will the IRS cut her any slack because she is still $30,000 in the red ($280,000 of debt compared to $250,000 sale price)? Nope. The sad truth is that it is possible to have a tax gain without actually having any cash to show for it. Mortgage debt does not affect the gain/loss calculation.

The good news is that Frances can probably exclude the $60,000 gain for federal income tax purposes, thanks to the IRC Section 121 home sale gain exclusion break explained earlier in this chapter. An unmarried person can exclude gain of up to $250,000, and married joint filers can exclude up to $500,000. Assuming Frances qualifies for the exclusion, the $60,000 gain won't trigger any federal income tax bill. Depending on her state of residence, there may or may not be a state income tax bill.

Of course, it is also possible to have a short sale for less than what was paid for the property.

Example 4-24

Walt paid $310,000 for a residence that he could now sell for only $250,000. The first and second mortgages recourse against the property total $280,000. Walt will have a $60,000 loss if he sells ($250,000 sale price – $310,000 basis = $60,000 loss). Does the IRS allow him to write off his loss? Sorry, but no. A taxpayer can only claim a tax loss on investment property. A loss on a personal residence is generally considered a nondeductible personal expense. In most states, the same principle applies for state income tax purposes.

What happens with the $30,000 that is still owed to the mortgage lender in both of the preceding examples ($280,000 of debt versus $250,000 sale price)? Usually, the lender will not give individuals any relief. They will have to pay off the $30,000, and they will not get any tax deductions for doing so. However, if the lender decides to forgive some or all of the unpaid $30,000, the forgiven amount constitutes so-called cancellation of debt (COD) income for federal income tax purposes.

Short Sales Involving Nonrecourse Debt

You might encounter a short sale in which the mortgage loan is nonrecourse. In this case, the lender cannot go after the borrower for any deficiency (negative difference between the sale price and the mortgage loan balance). Nevertheless, the lender agrees to go along with the deal in order to collect what can be collected now, before the property's value declines any further.

When property subject to a nonrecourse loan is sold in a short sale, the transaction is apparently treated for federal income tax purposes as a sale for proceeds equal to the nonrecourse loan balance. The actual sale price is apparently irrelevant.[51] There cannot be any COD income, because the borrower's nonrecourse mortgage obligation is deemed to be fully satisfied in the deal (that is, the lender's only remedy against the borrower is to take control of the property, and the lender gives up that right by agreeing to the short sale). Therefore, on the borrower's side of the deal, the short sale can only result in straightforward gain or loss. A tax gain will be triggered if the nonrecourse loan balance exceeds the property's basis. However, with a principal residence loan, the borrower can often exclude the entire gain under the IRC Section 121 home sale gain exclusion rules. If the property's basis exceeds the nonrecourse loan balance, the short sale will trigger a nondeductible loss in the case of a personal residence. In the case of a business or investment property, the loss will be a tax-favored IRC Section 1231 loss.

Tax Rules for Cancellation of Debt Income

The general rule states that COD income is a taxable item.[52] For the year COD occurs, the lender is supposed to report the income amount to the borrower (and to the IRS) on Form 1099-C (Cancellation of Debt). As stated earlier in this chapter, the borrower generally

[51] See *Tufts,* AFTR 2d 83-1132 (U.S. 1983).

[52] IRC sec. 61(a)(12).

must include the amount as income on that year's Form 1040 (U.S. Individual Income Tax Return). However, IRC Section 108 provides several exceptions to the general rule that COD income is taxable. The IRC Section 108 exceptions most likely to apply to personal residence mortgage debt are briefly explained in the following sections.

Bankruptcy Exception

If the borrower is in bankruptcy proceedings when COD occurs, it is entirely excluded from taxation. In other words, it is tax-free.[53]

Insolvency Exception

If the borrower is insolvent (that is, with debts in excess of assets), the COD income is entirely excluded from taxation as long as the borrower is still insolvent after the COD occurs. On the other hand, if the COD causes the borrower to become solvent, part of the COD income is taxable to the extent it causes solvency, and the rest is tax-free.[54]

Deductible Interest Exception

To the extent COD income consists of unpaid mortgage interest added to the loan principal and then forgiven, the amount of COD income that consists of forgiven interest that the borrower could have deducted if he or she had actually paid it is tax-free.[55]

Seller-Financed Debt Exception

If COD income is from forgiven seller-financed debt (that is, mortgage debt that was owed to the previous owner of the property), it is tax-free. However, the tax-free amount is then subtracted from the basis of the home. If the client later sells the property for a gain, the gain will be that much bigger. As mentioned earlier in this chapter, however, the client can probably exclude the gain under the IRC Section 121 home sale gain exclusion rules.[56]

Principal Residence Mortgage Debt Exception

This exception, explained subsequently, is the most likely candidate to help your homeowner clients for COD that occurs in 2007–12.[57]

> **Key Point:** COD income does not qualify for the IRC Section 121 home sale gain exclusion. This fact was confirmed in a case involving a personal residence short sale.[58] Therefore, COD income from a principal residence mortgage will be taxable unless an IRC Section 108 exception applies.

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[53] See IRC sec. 108(a)(1)(A).

[54] See IRC sec. 108(a)(1)(B).

[55] See IRC sec. 108(e)(2).

[56] See IRC sec. 108(e)(5).

[57] See IRC sec. 108(h).

[58] See *Gale, Robert G.* (TC Summary Opinion 2006-152).

Foreclosures

Up until now, this chapter has only dealt with short sales in which the home is sold to a third party. But what happens if the mortgage lender forecloses? A foreclosure occurs when a mortgage borrower defaults and the mortgage lender seizes the mortgaged property in order to sell it before things get worse.

Deed in Lieu of Foreclosure

Sometimes the borrower and lender will mutually agree on a so-called deed in lieu of foreclosure transaction. This is a voluntary deal on both sides, and it can be beneficial for both sides because the legal costs of a full-fledged foreclosure are avoided. For the borrower, the tax consequences of a deed in lieu transaction and a regular foreclosure are the same.

More Than One Mortgage

When there are several mortgages against a property, any of the mortgage lenders can potentially initiate foreclosure proceedings.

Example 4-25

Stuart's principal residence is burdened by a $300,000 first mortgage and a $100,000 home equity loan (second mortgage). Stuart is current on the first, but he has stopped paying the second. The second mortgage lender can initiate foreclosure proceedings, even though Stuart is current on the first mortgage.

In foreclosure, the second mortgage lender's rights are generally the same as the first mortgage lender's rights, with one big difference: the first mortgage generally must be paid in full before the second mortgage lender can collect anything. The two lenders may cooperate as they attempt to protect their respective interests. For example, the first mortgage lender could offer to buy the second mortgage (probably for less than the outstanding principal) and try to work things out with the borrower. If that effort fails, the first mortgage lender, who now owns both loans, could foreclose later on.

Recourse versus Nonrecourse Mortgages

The foreclosure transaction is not necessarily the end of the story if the mortgage is a recourse loan. With a recourse mortgage, the lender can pursue the borrower for any negative difference (deficiency) between the foreclosure sale proceeds and the loan balance plus foreclosure costs. It can potentially take many months, or even several years, before the borrower finally learns his or her fate.

In contrast, when a mortgage is a nonrecourse loan, the lender's only remedy is to seize the property and sell it. If there is a deficiency, it is the lender's problem, because the lender cannot go after the borrower to collect the deficiency. In some states, first mortgages taken out to acquire principal residences are nonrecourse but second mortgages are recourse. In

this scenario, the second mortgage lender can initiate foreclosure proceedings and pursue the borrower for any deficiency on the second, but the first mortgage lender cannot pursue the borrower for any deficiency on the first.

Federal Income Tax Impact of Foreclosure on Borrower

For the borrower, the most important variable in determining the federal income tax consequences of a foreclosure transaction (or deed in lieu of foreclosure transaction) is whether the mortgage is recourse or nonrecourse. In the case of a recourse mortgage, the other important variable for the borrower is whether the foreclosed home is worth more or less than the loan balance. In the case of a nonrecourse mortgage, the value of the foreclosed home is irrelevant, as discussed subsequently.

Recourse Mortgage: Property Worth Less Than Loan Balance

When the property's fair market value (FMV) is less than the recourse loan balance (the most common situation), the tax rules treat the foreclosure as a sale of the property for the FMV figure.[59] Therefore, a tax gain will be triggered if the property's FMV exceeds its basis. However with a principal residence loan, the borrower can often exclude the entire gain under the IRC Section 121 home sale gain exclusion rules discussed earlier in this chapter.

If the property's basis exceeds the FMV, the foreclosure will trigger a nondeductible loss in the case of a personal residence. In the case of a business or rental property, the loss will be a tax-favored IRC Section 1231 loss. If the lender then forgives all or part of the difference between the higher amount of the mortgage debt and the lower FMV figure, the forgiven amount constitutes COD income. As explained earlier in this chapter, COD income counts as taxable gross income unless the borrower qualifies for an exception under the IRC Section 108 rules.

Example 4-25A

Teri borrowed heavily against the value of her home when real estate was booming. The property was burdened by a recourse first mortgage of $360,000 and a recourse second mortgage of $200,000 (that is, total recourse debt of $560,000). When Teri stopped paying the second mortgage, the lender foreclosed. The home's FMV was $500,000. The property's tax basis was $420,000, and the entire $360,000 first mortgage balance was paid off and $140,000 of the second mortgage was paid off when the property was sold. Teri scraped up $10,000 to pay off part of the remaining $60,000 second mortgage balance. The second mortgage lender then forgave the last $50,000.

The foreclosure triggers an $80,000 gain on sale ($500,000 FMV – $420,000 tax basis). The gain can be excluded under the IRC Section 121 home sale gain exclusion rules, assuming Teri qualifies.

The $50,000 forgiven by the second mortgage lender is COD income. Teri must report it as gross income unless she qualifies for an exception under the IRC Section 108 rules.

[59] See Treas. Reg. 1.1001-2(c), example 8 and Rev. Rul. 90-16.

Variation

The second mortgage lender pursues Teri for the $50,000 deficiency. In this scenario, there is no COD income until the lender ultimately decides to forgive some or all of the deficiency, which may or may not happen. Until it does happen, there is nothing to report on Teri's tax returns with respect to the deficiency.

Recourse Mortgage: Property Worth More Than Loan Balance

When the property's FMV exceeds the recourse loan balance (a somewhat rare situation), the foreclosure is treated as a deemed sale of the property for a price equal to the loan balance, plus any additional proceeds received by the borrower from the foreclosure sale.[60] However, if the costs of the foreclosure proceedings and sale are large enough to result in a deficiency (that is, there is still an unpaid loan balance when all is said and done), the borrower falls back under the aforementioned rules that apply when the property is worth less than the loan balance. If the lender later forgives all or part of the deficiency, the forgiven amount constitutes cancellation of debt income. (See example 4-25A.)

Nonrecourse Mortgage

When property subject to a nonrecourse loan is foreclosed by the nonrecourse lender, the foreclosure is treated for federal income tax purposes as a deemed sale of the property to the lender for proceeds equal to the nonrecourse loan balance. The property's FMV is irrelevant,[61] and the lender cannot pursue the borrower for any deficiency.

Because the taking of the property in foreclosure is deemed to fully satisfy the borrower's nonrecourse debt obligation, there cannot be any COD income for the borrower with respect to the nonrecourse debt. There can only be gain or loss from the deemed sale. A tax gain is triggered if the nonrecourse loan balance exceeds the property's basis. However, with a principal residence loan, the borrower can often exclude the entire gain under the IRC Section 121 home sale gain exclusion rules discussed earlier in this chapter.

If the property's basis exceeds the nonrecourse loan balance, the foreclosure triggers a nondeductible loss in the case of a personal residence. In the case of a business or rental property, the loss will be a tax-favored IRC Section 1231 loss.

Example 4-25B

Steve borrowed heavily to acquire his principal residence a few years ago when real estate prices were rising. Then, he thought he made a real killing when he found a lender willing to give him a big nonrecourse home equity line of credit (HELOC). When Steve stopped paying the HELOC, the lender foreclosed. At that time, the property was burdened by a $175,000 first mortgage balance and a $100,000 HELOC balance (total nonrecourse debt of $275,000). The property's tax basis was only $180,000. Under the aforementioned deemed sale treatment, the foreclosure triggered a $95,000 tax gain ($275,000 total nonrecourse debt balance – $180,000 tax basis; the property's FMV is irrelevant). For purposes of this example, Steve can exclude the entire gain under the IRC Section 121 home sale gain exclusion rules. That

[60] See Treas. Reg. 1.1001-2(a)(1).

[61] *Tufts*, AFTR 2d 83-1132 (U.S. 1983).

is the end of the story for him, because the mortgage lenders cannot come after him for any deficiency. Good deal for Steve!

Variation

Steve's property is a vacation home. The $95,000 gain will be a long-term capital gain that cannot be excluded under the IRC Section 121 rules. Therefore, Steve will pay tax on the whole gain unless he has some offsetting capital losses. The good news is the mortgage lenders cannot come after him for any deficiency.

> **Key Point:** Compared to what happens with recourse debt foreclosures, the deemed sale treatment for nonrecourse debt foreclosures can sometimes be unfavorable for borrowers. With recourse debt, a foreclosure may result in COD income that the borrower can exclude from gross income under one of the IRC Section 108 rules summarized earlier in this chapter. With nonrecourse debt, however, any gain that cannot be excluded under the IRC Section 121 rules may wind up being fully taxable, unless the debtor has losses to offset the gain. (See example 4-25B.)

Reporting and Treatment of COD Income Arising From Foreclosures

COD income after a foreclosure must be reported as taxable gross income on the borrower's federal income tax return unless the borrower qualifies for an exception under the IRC Section 108 rules explained earlier in this chapter.

In theory, a recourse mortgage lender is supposed to report COD income to the borrower on a Form 1099-C issued for the year during which the debt cancellation is deemed to occur. In the real world, however, Form 1099-C is sometimes issued for the wrong year and reported COD amounts are sometimes wrong too.

For example, in *Gaffney*, a U.S. Tax Court summary opinion addressed a situation in which the borrower's home was foreclosed by the recourse mortgage lender in 1994. The lender charged off the loan in 1995. In 2006, the lender finally got around to issuing a Form 1099-C, but it showed the wrong first name for the borrower and was sent to an address the borrower had not used for eight years (a comedy of errors). The Tax Court concluded there was no identifiable debt cancellation event in 2006, so the borrower did not have to report any COD income for that year (the wrong address was not relevant in this case). Obviously, the actual debt cancellation event had occurred long before 2006 in a tax year that was closed by the time the Form 1099-C was issued. Thus, the borrower was in the clear tax-wise.[62]

For two other recent Tax Court decisions involving erroneous Forms 1099-C, see *Thomas Linkugel*, TC Summary Opinion 2009-180 (2009), and *William McCormick*, TC Memo 2009-239 (2009).

[62] See *Dennis Gaffney*, TC Summary Opinion 2010-128 (2010).

Exclusion for Principal Residence Mortgage Debt Discharges Will Save the Day for Many Clients

As previously discussed, for federal income tax purposes, COD income is taxable unless a specific exception makes it tax-free. The Mortgage Forgiveness Debt Relief Act of 2007 created a new exception for qualifying discharges of home mortgage debt in 2007–9. Then the Emergency Economic Stabilization Act of 2008 extended the exception through 2012.[63]

Under the exception, an individual taxpayer can exclude up to $2 million of COD income from a discharge of "qualified principal residence indebtedness" which means debt that was used to acquire, build, or improve the taxpayer's principal residence (as defined under the IRC Section 121 home sale gain exclusion rules explained earlier in this chapter) and that is secured by that residence. Refinanced debt can qualify to the extent it replaces debt that was used to acquire, build, or improve the taxpayer's principal residence. The basis of the taxpayer's principal residence is reduced (but not below zero) by the amount of COD income that is excluded under this rule.

Note that this exception is not available to taxpayers in Title 11 bankruptcy cases. Finally, an insolvent individual can elect to forego this exception and instead rely on the more general exception for insolvent taxpayers under IRC Section 108(a)(1)(B).

> **Key Point:** The exception only applies to COD income from debt used to acquire, build, or improve a principal residence. COD income from discharges of home equity loans used for other purposes will not qualify for the new exception, nor will COD income from discharges of vacation home loans. However other exceptions under IRC Section 108 may allow clients to exclude COD income in these circumstances.

Tax Angles When Client Converts Personal Residence Into Rental Property

In this economy, it can be difficult, if not impossible, to sell a home for an acceptable price. Clients may be considering converting their principal residences into rental properties until the local real estate market improves, especially if they have already bought another home and are now paying two mortgages, two property tax bills, and so forth. However, converting a former principal residence into a rental has some tricky tax implications.

Basis for Loss and Depreciation Purposes Depends on Market Value

Clients cannot claim a tax loss when their principal residence is sold for less than tax basis. The privilege of claiming tax losses is reserved for sales of property used for business or investment purposes. In most cases, basis equals the original purchase price plus the cost of

[63] See IRC sec. 108(h).

any improvements (not counting normal repairs and maintenance) minus any depreciation deductions (for example, from a deductible office in the home).

However, if your client converts his or her principal residence into a rental and eventually sells the home for less than tax basis, can he or she deduct the entire loss as an IRC Section 1231 loss (assuming the property has been owned for over one year)? No! Sadly, a special basis rule prevents that taxpayer-friendly outcome. The special rule states when a taxpayer converts a former principal residence into a rental, the initial tax basis for calculating any later loss on sale equals the lesser of (1) the property's basis on the conversion date under the normal rule or (2) the property's FMV on the conversion date.[64]

In effect, the special basis rule disallows the loss from a decline in value that occurs *before* the conversion date. However, a *post-conversion* decline *will* result in an allowable IRC Section 1231 loss (assuming the property has been owned for over one year) to the extent it is not offset by depreciation writeoffs. Because depreciation lowers the property's tax basis for loss purposes, it makes it that much harder to have a loss.

Your client must use the same unfavorable special basis rule to figure his or her initial tax basis for calculating depreciation deductions on the converted property.[65] (The client can depreciate basis allocable to the building—not the land—over 27.5 years.)

Tax Basis for Gain Purposes Is Different

If the value of a converted property recovers, and your client sells for a profit down the road, the property's tax basis for gain purposes is determined under the normal basis rule. The rule, as mentioned earlier in this chapter, usually equals the purchase price plus the cost of improvements minus depreciation deductions including depreciation after the property is converted into a rental.

> **Key Point:** If a former principal residence is sold within three years after it is converted into a rental, the IRC Section 121 home sale gain exclusion break explained earlier in this chapter will usually be available. However, gains attributable to depreciation cannot be sheltered by the IRC Section 121 exclusion.[66]

Different Basis Numbers Can Create Weird Results When Property Is Sold

Because the special basis rule that is used for tax loss purposes is different than the normal basis rule that is used for tax gain purposes, your client can potentially wind up in never-never land, where he or she has neither a tax gain nor a tax loss. This will happen if the sale price falls between the two basis numbers. Needless to say, this is all very confusing. The following examples illustrating tax results with differing conversion date FMVs and sale prices.

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[64] See Treas. Reg. 1.165-9(b)(2).

[65] See Treas. Reg. 1.168(i)-4(b).

[66] See IRC sec. 121(d)(6).

Example 4-26

Tax Loss on Sale

1. Basis on conversion date under normal rule	$300,000
2. FMV on conversion date	235,000
3. Post-conversion depreciation deductions	13,000
4. Basis for tax loss (line 2 – line 3)	222,000
5. Basis for tax gain (line 1 – line 3)	287,000
6. Net sale price (after selling expenses)	205,000
7. Tax loss (excess of line 4 over line 6)	17,000
8. Tax gain (excess of line 6 over line 5)	N/A

Explanation: In this example, there is an allowable tax loss because the property continued to decline in value after the conversion date.

Example 4-27

Tax Gain on Sale

1. Basis on conversion date under normal rule	$300,000
2. FMV on conversion date	285,000
3. Post-conversion depreciation deductions	16,000
4. Basis for tax loss (line 2 – line 3)	269,000
5. Basis for tax gain (line 1 – line 3)	284,000
6. Net sale price	295,000
7. Tax loss (excess of line 4 over line 6)	N/A
8. Tax gain (excess of line 6 over line 5)	11,000

Explanation: In this example, the tax gain is caused by the post-conversion depreciation deductions plus a recovery in value after the conversion date.

Example 4-28

No Tax Gain or Loss

1. Basis on conversion date under normal rule	$300,000
2. FMV on conversion date	235,000
3. Post-conversion depreciation deductions	13,000
4. Basis for tax loss (line 2 – line 3)	222,000
5. Basis for tax gain (line 1 – line 3)	287,000
6. Net sale price	260,000
7. Tax loss (excess of line 4 over line 6)	N/A
8. Tax gain (excess of line 6 over line 5)	N/A

Explanation: In this example, there is no tax gain or loss because the sale price falls between the two basis numbers.

Keep Records to Establish FMV on Conversion Date

An important thing to remember is that the property's FMV on the conversion date is often the most important factor in determining the tax results from a later sale. It is essential to make sure your client has some evidence for that (for example, a market evaluation from a local realtor). This information should be kept with the client's tax records.

Schedule E Deductions Are Allowed When Converted Residence Is Held Out for Rent Even When There Is No Rental Income

IRC Section 212 allows individual owners of rental properties to claim Schedule E deductions for expenditures associated with the production of rental income (subject to the passive activity loss [PAL] rules). As a 2011 Tax Court Summary Opinion states, deductions are allowed when a property is held out for rent even during periods when there is no rental income.

In *Hattie M. Bonds*, the taxpayer moved from Kansas City to Minnesota in 1988. From the time of the move through 2004 or 2005, she was able to rent out her former Kansas City principal residence. However, in 2006 and 2007, there was no rental income even though the property was available for rent. The failure to rent the property was apparently due to several factors, including a lousy local economy and the property's suboptimal location. The taxpayer continued to own the property, because a realtor told her she could still sell it for a profit. After her move to Minnesota, the taxpayer did not use the property for personal purposes, and it was never actually put up for sale.

On her 2006 and 2007 returns, the taxpayer claimed Schedule E rental losses from the Kansas City property of about $13,000 and $12,700, respectively. Claimed expenses included mortgage interest, property taxes, utilities, cleaning and maintenance, insurance, advertising, depreciation, and the cost of traveling by car to visit the property. As previously stated, there was no rental income in either 2006 or 2007. The lack of rental income apparently triggered an IRS audit of the taxpayer's 2006 and 2007 returns, and the government completely disallowed the Schedule E losses claimed on those returns. The IRS used three different arguments:

1. The taxpayer continued to own the Kansas City property for personal reasons, because family and friends lived in the area, and because she wanted to retire there without any intention to rent it out for income. Claiming expenses on Schedule E was not allowed, because using Schedule E requires an intention to produce rental income.
2. Even if the taxpayer was entitled to claim rental expenses on Schedule E, she could not currently deduct the net Schedule E losses from 2006 and 2007 because the losses were suspended by the PAL rules due to a lack of passive income.
3. The taxpayer had no substantiation for some of her claimed expenses.

The IRS *did allow* Schedule A itemized deductions for mortgage interest and property taxes.

The disgruntled taxpayer went to the Tax Court seeking justice. She represented herself under the IRC Section 7463 "small case" Tax Court rules.

In its summary opinion, the Tax Court declared that the taxpayer was indeed entitled to deduct Schedule E net rental losses for 2006 and 2007 even though there was no rental income for those years. The Tax Court pointed out that the government's own rules say that holding property for the production of income can include income expected in future years including an anticipated gain on sale in a future year.[67] In 2006 and 2007, the taxpayer had good reason to believe she could sell the property for a gain, because of her realtor's advice.

The Tax Court then rejected the IRS argument that the taxpayer's net rental losses were suspended by the PAL rules. Because she met the active participation requirement, she was eligible for the IRC Section 469(i) exception that allows individuals to currently deduct up to $25,000 of annual passive losses from rental real estate activities. (The $25,000 allowance is phased-out at higher income levels.) However, the Tax Court agreed that some of the taxpayer's claimed deductions were unsubstantiated and should be disallowed or only partially allowed for that reason.

When all was said and done, the taxpayer was allowed to deduct about half of her claimed Schedule E net losses. The other half was disallowed due to lack of substantiation.[68]

> **Key Point:** The main message of the *Bonds* decision is that an individual's net rental losses from a property held out for rent can be deducted on Schedule E even when there is no rental income. The secondary message is that claimed expenses must be substantiated with decent records.

Reverse Mortgages Can Be a Tax-Smart Deal for Seniors With Greatly Appreciated Residences

Despite the generally dreadful residential real estate market, quite a few folks who live in expensive areas still own greatly appreciated homes, especially when the homes have been owned for many years. Although big appreciation is good for the homeowner, a not-so-good side effect is the fact that selling a highly appreciated principal residence will trigger a gain well in excess of the IRC Section 121 home sale gain exclusion limit. Under the gain exclusion break, married couples can exclude gains of up to $500,000, and unmarried individuals can exclude gains of up to $250,000. Obviously, these seemingly generous limits will not be nearly enough to shelter a really big home sale profit. There may also be a significant state income tax hit. Even with advantageous capital gain tax rates, the combined federal and state tax rate on the nonexcludable portion of the gain can approach 25 percent or more in

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[67] Treas. Reg. 1.212-1(b).

[68] See *Hattie M. Bonds*, TC Summary Opinion 2011-122 (2011).

high-tax states. Therefore, the tax hit from selling a highly-appreciated home can easily be several hundred thousand dollars and up.

Therein lies the problem, which can be especially acute for older homeowners who are house-rich but cash-poor. What can clients who find themselves in this category do when cash is required? An obvious potential solution is to sell that greatly appreciated home and thereby convert all that equity into cash.

Although the saying "do not let the tax tail wag the dog" is generally very sound advice, this is one time when letting the tax tail take charge might actually be the smart thing to do, because selling a greatly appreciated home could easily trigger federal and state income tax bills in the hundreds of thousands of dollars. Once the home is sold, all those tax dollars will be gone forever—which is not good!

Basis Step-Up Rule to the Rescue

On the other hand, if the client continues to own his highly appreciated residence until he or his spouse departs for a better place, the result could be a greatly reduced or maybe even completely eliminated federal income tax bill when the property is eventually sold. This taxpayer-friendly outcome is thanks to IRC Section 1014(a), which generally allows an unlimited federal income tax basis step-up for appreciated capital gain assets owned by a person who passes away.

Under this rule, the tax basis of most appreciated capital gain assets owned by decedents, including personal residences, are stepped up to FMV as of the date of death (or the alternate valuation date six months later, if elected). When the value of an asset eligible for this favorable rule stays about the same between the date of death and the date of sale by the decedent's heirs, there will be little or nothing to report to the IRS because the sales proceeds will be fully offset, or nearly so, by the asset's stepped-up basis.

For example, if a client is married and his or her spouse predeceases her, the basis of the portion of the home owned by the client's departed mate, typically 50 percent, gets stepped up to FMV. This removes half of all the appreciation that has occurred over the years from the federal income tax rolls. So far, so good. If your client then continues to hold onto the home until she dies, the basis of the part she owns at that point, which will be 100 percent in most cases, gets stepped up to FMV as of the date of death. So the client's heirs can sell the property and owe little or nothing to the U.S. Treasury. The heirs will be delighted!

If client and spouse own the home together as community property, the tax basis of the entire residence is generally stepped up to FMV when the first spouse dies, not just the 50 percent portion that was owned by the now-deceased spouse. This weird-but-true rule means the surviving spouse can then sell the property and owe little or nothing to the IRS.[69] In other words, if your client turns out to be the surviving spouse, he or she will not need to hold onto the property until death-do-us-part in order to reap the full tax-saving advantage of the basis step-up. Of course, if the client wants to hold on, he or she can. He or she can choose to sell or not sell without facing any adverse federal income tax implications either way. Of course, if your client is unmarried and

[69] IRC sec. 1014(b)(6).

owns the greatly appreciated home by him or herself, the tax results are much easier to understand. The basis of the entire property gets stepped up to FMV when he or she passes on, and his or her heirs can then sell the residence and owe little or nothing to Uncle Sam.

> **Key Point:** Hanging onto a highly appreciated residence until death (or until the spouse's death when the homeowner is married) can save a ton of taxes thanks to the basis step-up deal. However, if the client needs cash to keep going, he or she should consider a reverse mortgage, as discussed in the following section.

> **Key Point:** The rule allowing the basis of all appreciated capital gain assets to be stepped up to the date-of-death FMV was restored for 2011 and beyond by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (better known as the Bush tax cut extension legislation). For decedents who died in 2010, the simple-and-easy unlimited basis step-up rule was replaced by an election also allowing an alternative complicated modified carryover basis rule that limited basis step-ups to a maximum of $1.3 million plus up to another $3 million for assets inherited by a surviving spouse.[70]

Reverse Mortgage Basics

When an individual takes out a regular home loan, he or she has to make monthly principal and interest payments to the lender. With a reverse mortgage, the lender makes one or more payments to the individual, that is, the borrower. No payments to the lender are required until a triggering event occurs, such as when the homeowner dies or moves out. Meanwhile, the accrued interest builds up, and the loan balance gets larger rather than smaller, which is why it is called a reverse mortgage.

Taking out a reverse mortgage can give an older homeowner access to needed cash without selling the property. In fact, many older homeowners may not qualify for a conventional "forward" home equity mortgage or line of credit because they lack the requisite income. For them, a reverse mortgage may be the *only way* to convert home equity into cash without selling. Clients can receive reverse mortgage proceeds as a lump sum, in installments over a period of months or years, or as line-of-credit withdrawals when they need cash.

These days, most reverse mortgages are home equity conversion mortgages (HECMs), which are insured by the federal government. An individual must be at least 62 years old to qualify. For 2012, the absolute maximum amount that can be borrowed under an HECM is $625,500. However, the actual lending limit depends on the value of the client's home, the client's age, and the amount of any other mortgage debt against the property. For example, a 65-year-old can usually borrow about 25 percent of his or her home equity. The percentage rises to about 40 percent if an individual is 75 and to about 60 percent if an individual is 85.

Interest rates can be fixed or variable depending on the deal selected. Rates are somewhat higher than for regular home loans, but not a lot higher.

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[70] See IRC secs. 1014(c) and 1022 (now repealed) and Section 301 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

As previously stated, a reverse mortgage does not require any payments to the lender until the borrower moves out of the mortgaged property or dies. At that time, the property is usually sold, and the reverse mortgage balance is paid off out of the sales proceeds. Any remaining proceeds go to the homeowner or his or her estate.

> **Key Point:** Taking out a reverse mortgage can allow a cash-strapped but house-rich senior to avoid having to sell a greatly appreciated home and thereby allow him or her to avoid triggering large tax bills. As explained previously, those tax bills can be greatly reduced or perhaps even completely eliminated by continuing to own the home until the bitter end.

Fees Are High

Fees to take out and maintain a reverse mortgage will usually be considerably higher than for a regular "forward" home equity loan or line of credit. With an HECM, an individual will pay an origination fee equal to 2 percent of the first $200,000 of the "maximum claim amount" (a figure that depends on the Federal Housing Authority [FHA] loan limit for his or her area and his or her home's value) plus 1 percent of any maximum claim amount greater than $200,000. However, the origination fee cannot exceed $6,000. The individual will also be charged a first-year FHA mortgage insurance premium (MIP) equal to 2 percent of the home's maximum claim amount. In later years, the annual MIP will equal 1.25 percent of the outstanding loan balance. (Greatly reduced MIP charges are available for eligible smaller loans.) In addition, the lender can charge a monthly servicing fee of $30–$35. Typically, the familiar home mortgage closing costs, such as title insurance, an appraisal, settlement services, and so forth, are also included. All these amounts are deducted from the reverse mortgage loan amount, and they can add up to big bucks. For instance, the total fees on a $450,000 reverse mortgage could be around $21,000, which would reduce the actual available credit amount to about $429,000.

Fees for lenders' proprietary reverse mortgage products, a small percentage of the market, may vary widely from what has been provided in this discussion.

> **Key Point:** The reverse mortgage market is still in its infancy and is still evolving. Therefore, research is required to find the best product for a particular client situation.

Deducting Reverse Mortgage Interest

The first $100,000 of reverse mortgage principal will often qualify as home equity indebtedness under IRC Section 163(h). If so, a borrower can claim an itemized deduction for the related interest expense because it will meet the definition of qualified residence interest.

In general, no interest deduction is allowed for alternative minimum tax purposes unless the reverse mortgage proceeds are spent to acquire, construct, or improve the borrower's first or second home.[71] Typically, reverse mortgage proceeds will not be used for that purpose.

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[71] See IRC sec. 56(b)(1)(C)(1)(i) and (e).

Assuming the borrower is a cash-basis taxpayer, reverse mortgage interest cannot be deducted until it is paid in cash.[72] Because reverse mortgage interest is usually added to the loan principal, payment may not occur until long after the mortgage is taken out.

> **Key Point:** In many cases, there will not be much of a tax benefit from reverse mortgage interest expense. However, hanging onto a greatly appreciated home until death could save a client a ton in taxes.

Other Reverse Mortgage Considerations

Your client may object to the notion of borrowing against his or her home to solve a cash flow problem. Fair enough, but please keep the following facts in mind and explain them to the client. The cash he or she needs must come from somewhere, and it will be gone after the client has spent it, regardless of the source. If the cash comes from selling the client's greatly appreciated home, the cost of getting his or her hands on the needed money will be a big tax bill. In contrast, if the needed cash comes from a reverse mortgage, the only cost will be loan fees and interest charges. Those may be a tiny percentage of the taxes the client could permanently avoid by continuing to own the home (if they are not a tiny percentage, this is not such a great idea). Of course, the client's need for cash and his or her desire to avoid triggering taxes might not be the only issues. The client may strongly prefer to sell his or her home for other valid reasons, which is fine, but he or she needs to be prepared for the horrifying tax hit. However, when the client would be quite satisfied to remain in his or her home for as long as he or she can manage to pay the bills, the reverse mortgage idea may be the best tax-smart strategy.

Beware of Homebuyer Tax Credit Repayment Rules

One of the new things for the 2012 tax filing season is the likelihood that you will have some individual clients who are required to repay part or all of their previously claimed IRC Section 36 first-time homebuyer tax credits with their 2011 Form 1040.

- Individuals who claimed credits for 2008 principal residence purchases generally must pay them back over 15 years starting with their 2010 returns and continuing for 2011.
- Individuals who claimed credits for 2008 or 2009 home purchases may have to repay them in full with their 2011 returns if they stopped using the homes as their principal residences during 2011.

> **Key Point:** The fact that the credit repayment rules exist will probably come as a complete and unpleasant surprise to most individuals who are affected by them.

72 See Rev. Rul. 80-248.

Homebuyer Credit Basics

Before covering how the credit repayment rules work, the following sections will provide a summary of how the credit rules themselves work. Repetitive law changes created three different versions of the credit.

Version 1

The original version of the IRC Section 36 credit was enacted as part of the Housing Assistance Tax Act of 2008. It allowed a credit of up to $7,500 to individuals who bought U.S. principal residences between April 9, 2008, and December 31, 2008. To be eligible, the buyer could not have owned another principal residence during the 3-year period ending on the purchase date. In the case of married couples, both spouses must pass the 3-year test. Under this version, the maximum credit amount was the *lesser* of (1) 10 percent of the purchase price, (2) $7,500, or (3) $3,750, if the buyer used married filing separate status.

Version 2

The second version of the IRC Section 36 credit was enacted as part of the American Recovery and Reinvestment Act of 2009 (better known as the Stimulus Act). It originally allowed a credit of up to $8,000 to individuals who bought U.S. principal residences between January 1, 2009, and November 30, 2009. However, as explained subsequently, the closing deadline was extended twice. To be eligible, the buyer could not have owned another principal residence during the 3-year period ending on the purchase date. In the case of married couples, both spouses must pass the 3-year test. Under this version, the maximum credit amount was the *lesser* of (1) 10 percent of the purchase price, (2) $8,000, or (3) $4,000, if the buyer used married filing separate status.

The Worker, Homeownership, and Business Assistance Act of 2009 extended the closing deadline for Version 2 beyond the original November 30, 2009, date to April 30, 2010, or June 30, 2010, for homes that were under contract as of April 30, 2010. Then, the Homebuyer Assistance and Improvement Act of 2010 further extended the closing deadline to September 30, 2010, for homes that were under contract as of April 30, 2010, and were contracted to close by June 30, 2010, but did not.[73]

Version 3

The third version of the IRC Section 36 credit is the so-called longtime homeowner credit. It was enacted as part of the Worker, Homeownership, and Business Assistance Act of 2009. It allowed a credit of up to $6,500 to so-called longtime homeowners, which means those who had owned a U.S. principal residence for at least 5 consecutive years during the 8-year period ending on the purchase date for a replacement U.S. principal residence. In the case of married individuals, both spouses must pass the 5-out-of-8-years test. Under this version, the maximum credit amount was the *lesser* of (1) 10 percent of the purchase price, (2) $6,500, or (3) $3,250, if the buyer used married filing separate status.

[73] See IRC sec. 36(h)(2).

Version 3 was originally available for purchases between November 7, 2009, and April 30, 2010, or June 30, 2010, for homes that were under contract as of April 30, 2010. Then, the Homebuyer Assistance and Improvement Act of 2010 extended the closing deadline to September 30, 2010, for homes that were under contract as of April 30, 2010, and were contracted to close by June 30, 2010, but did not.[74]

Phase-Out Rules

All three versions of the homebuyer credit were phased-out if the buyer's modified adjusted gross income exceeded certain thresholds. The phase-out thresholds were significantly lower for purchases that occurred before November 7, 2009.[75]

Repayment Rules for Version 1 (for 2008 Purchases)

General 15-Year Repayment Rule

Under the general repayment rule for Version 1 of the credit (that is, for purchases between April 9, 2008, and December 31, 2008), buyers are required to start repaying the credit in equal installments over 15 years, beginning with their 2010 Form 1040.[76] In other words, Version 1 was actually just an interest-free loan from the government, rather than a legitimate tax credit.

Special Accelerated Repayment Rule When Home Ceases to Be Taxpayer's Principal Residence

If during 2011, the buyer (or buyer's spouse, if applicable) ceased to use the home as a principal residence (because the home was sold or for any other reason), the remaining amount of the Version 1 credit (after subtracting the amount already recaptured in 2010) generally must be recaptured (repaid) with the 2011 Form 1040, subject to the gain limitation rule explained as follows.

If, and only if, the accelerated repayment rule is triggered by a sale of the home to an unrelated party, the gain limitation rule limits the credit recapture amount to the gain on sale, if any. For this specific purpose, the gain on sale is deemed to be the home's net sale price minus the home's tax basis plus the remaining (unrecaptured) homebuyer credit after considering amounts already recaptured under the 15-year repayment rule. In effect, the home's basis is decreased by the amount of the unrecaptured credit when applying the gain limitation rule.[77]

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[74] *Ibid.*

[75] *Ibid.*

[76] See IRC sec. 36(f)(1) and (f)(7).

[77] See IRC sec. 36(f)(2) and (3).

Key Point: Form 5405 (First-Time Homebuyer Credit and Repayment of the Credit) includes a worksheet to calculate the gain on sale for purposes of applying the gain limitation rule.

Exceptions to Repayment Rules

Military Service Exception

If the buyer (or spouse, if applicable) is in the military, intelligence community, or foreign service and must sell or cease using the home as a principal residence due to a government order to relocate for official extended duty service, both the 15-year repayment rule and the accelerated repayment rule are waived for the year of the sale or cessation of use and for all subsequent years. In other words, any remaining credit repayment obligation vaporizes when this exception applies.[78]

Transfer to Spouse Exception

If the buyer transfers ownership of the home to an ex-spouse in a tax-free IRC Section 1041(a) transaction pursuant to divorce, the transfer does not trigger the accelerated repayment rule. Any credit repayment obligation, under either the 15-year repayment rule or the accelerated repayment rule, for tax years ending after the transfer date becomes the ex-spouse's problem. The same treatment applies when ownership is transferred to a spouse outside of divorce in a tax-free IRC Section 1041(a) transaction (that is, any credit repayment obligation for tax years ending after the transfer date becomes the spouse's problem).[79]

Involuntary Conversion Exception

An involuntary conversion does not trigger the accelerated repayment rule if the buyer acquires a replacement principal residence within 2 years. However, the 15-year repayment rule continues to apply.[80]

Death Exception

Both the 15-year repayment rule and the accelerated repayment rule are waived for tax years ending after the date of the buyer's death. Therefore, a deceased buyer is let off the credit repayment hook and so are his or her heirs.[81]

2011 Credit Recapture Reporting and Payment Requirements

For the 2011 tax year, homebuyer credit recapture (repayment) amounts that are due under the 15-year recapture rule are reported as additions to the taxpayer's federal income tax

[78] See IRC sec. 36(f)(4)(E).
[79] See IRC sec. 36(f)(4)(C).
[80] See IRC sec. 36(f)(4)(B).
[81] See IRC sec. 36(f)(4)(A).

liability on line 59b of Form 1040. There is no need to file Form 5405. Credit recapture amounts should be paid by the Form 1040 filing deadline of April 17, 2012, to avoid the underpayment penalty. For extended returns, payment of credit recapture amounts can be made with Form 4868 (Application for Automatic Extension of Time To File U.S. Individual Income Tax Return) extension requests filed by the April 17, 2012 deadline.

Example 4-29

Hermione, an unmarried individual, claimed a $7,500 credit when she bought a home in 2008 for $250,000. She still owns and lives in the home. Under the 15-year repayment rule, Hermione must add $500 ($7,500/15) to her 2011 federal income tax liability by entering that amount on line 59b of her 2011 Form 1040. Assuming she continues to own the home, Hermione must repay another $500 with her return for each of the following 13 years (2012–24) until she has repaid the entire $7,500.

Example 4-30

Harry, an unmarried individual, claimed a $7,500 credit when he bought a home in 2008 for $250,000. He sold it in 2011. None of the exceptions to the accelerated credit repayment rule apply to Harry, so he must repay the lesser of (1) $7,000 ($7,500 minus the $500 already recaptured in 2010) or (2) the gain on sale (if any). To determine if Harry has a gain on sale for credit repayment purposes, he must reduce his tax basis in the home by the unrecaptured $7,000 credit.

Harry then sold the home for a net sale price of $247,500. For credit repayment purposes, he has a $4,500 gain calculated as follows: $247,500 net sale price minus $243,000 ($250,000 cost basis minus $7,000 unrecaptured credit) = $4,500. Harry must fill out Form 5405 and repay $4,500 (lesser of $7,000 unrecaptured credit or $4,500 gain on sale) with his 2011 Form 1040.

Variation A

Harry sold the home for $243,000 or less. In this case, he would have no gain on sale. Thanks to the gain limitation rule, he would not have to repay any of the credit.

Variation B

Harry was married when he bought the home in 2008. His wife permanently moves out in 2011 but Harry continues to live in the home. Under the accelerated repayment rule, Harry must fill out Form 5405 and repay the entire unrecaptured credit amount of $7,000 with his 2011 Form 1040. The gain limitation rule cannot help Harry in this circumstance because it only applies when the accelerated repayment rule is triggered by a sale to an unrelated party.

Repayment Rule for Versions 2 and 3 (for 2009 and 2010 Purchases)

Homebuyers who claimed Version 2 or 3 of the credit (for 2009 and 2010 purchases) are exempt from the 15-year repayment rule and the accelerated repayment rule. They only apply to Version 1 of the credit (for 2008 purchases).[82] However, repayment may still be required under another rule that applies to Versions 2 and 3.

[82] See IRC sec. 36(f)(4)(D)(i).

Repayment Required If Home Ceases to Be Principal Residence within Three Years

As a general rule, Versions 2 and 3 of the credit (for 2009 and 2010 purchases) must be recaptured (repaid), subject to the gain limitation rule explained subsequently if the buyer (or spouse if applicable) ceases to use the home as a principal residence because the home was sold or for any other reason within three years after the purchase date.[83]

If, and only if, the aforementioned repayment rule is triggered by a sale of the home to an unrelated party, the gain limitation rule limits the credit recapture amount to the gain on sale, if any. For this specific purpose, the gain on sale is deemed to be the home's net sale price minus the home's tax basis plus the full amount of the homebuyer credit. In effect, the home's basis is decreased by the amount of credit when applying the gain limitation rule.[84]

> **Key Point:** Form 5405 includes a worksheet to calculate the gain on sale for purposes of applying the gain limitation rule.

> **Key Point:** For Versions 2 and 3 of the credit (for 2009 and 2010 purchases), the credit repayment obligation vaporizes after the home has been owned and used as the buyer's (and spouse's, if applicable) principal residence for more than three years.

Exceptions to Repayment Rule

Military Service Exception

If the buyer, or spouse if applicable, is in the military, intelligence community, or foreign service and must sell or cease using the home as a principal residence due to a government order to relocate for official extended duty service, the repayment rule is waived for the year of the sale or cessation of use and for all subsequent years. In other words, any credit repayment obligation vaporizes when this exception applies.[85]

Transfer to Spouse Exception

If the buyer transfers ownership of the home to an ex-spouse in a tax-free IRC Section 1041(a) transaction pursuant to divorce, the transfer does not trigger the repayment rule. Any credit repayment obligation for tax years ending after the transfer date becomes the ex-spouse's problem. The same treatment applies when ownership is transferred to a spouse outside of divorce in a tax-free IRC Section 1041(a) transaction. Any credit repayment obligation for tax years ending after the transfer date becomes the spouse's problem.[86]

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[83] See IRC sec. 36(f)(4)(D)(ii).
[84] See IRC sec. 36(f)(2) and (3).
[85] See IRC sec. 36(f)(4)(E).
[86] See IRC sec. 36(f)(4)(C).

Involuntary Conversion Exception

An involuntary conversion does not trigger the repayment rule if the buyer acquires a replacement principal residence within two years.[87]

Death Exception

The repayment rule is waived for tax years ending after the date of the buyer's death. Therefore, a deceased buyer is let off the credit repayment hook and so are his or her heirs.[88]

2011 Credit Recapture Reporting and Payment Requirements

For the 2011 tax year, homebuyer credit recapture (repayment) amounts are calculated using Parts III and IV of Form 5405 which must be filed with the 2011 Form 1040. Credit recapture amounts are treated as federal income tax additions and must be reported as such on line 59b of Form 1040. Credit recapture amounts should be paid by the Form 1040 filing deadline of April 17, 2012, to avoid the underpayment penalty. For extended returns, payment of credit recapture amounts can be made with Form 4868 extension requests filed by April 17, 2012.

Example 4-31

Ingrid, an unmarried individual, claimed an $8,000 credit when she bought a home in 2009 for $250,000. She sold the home in 2011, and none of the exceptions to the credit repayment rule apply to her. Therefore, she must repay the lesser of (1) the full $8,000 credit or (2) the gain on sale (if any). To determine if she has a gain for credit repayment purposes, Ingrid must reduce her tax basis in the home by the $8,000 credit.

Ingrid sold the home for a net sales price of $247,000. She has a $5,000 gain for credit repayment purposes calculated as follow: $247,000 net sales price minus $242,000 ($250,000 cost basis minus $8,000 credit) = $5,000. Ingrid must repay $5,000 (lesser of $8,000 credit or $5,000 gain on sale) with her 2011 Form 1040.

Variation A: Ingrid sold the home for $242,000 or less. In this case, she would have no gain on sale. Thanks to the gain limitation rule, she would not have to repay any of the credit.

Variation B: Ingrid was married when she bought the home in 2009. Her husband permanently moves out in 2011, but Ingrid continues to live in the home. Under the repayment rule, Ingrid must repay the entire $8,000 credit with her 2011 Form 1040. The gain limitation rule cannot help Ingrid in this circumstance because it only applies when the repayment rule is triggered by a sale to an unrelated party.

[87] See IRC sec. 36(f)(4)(B).

[88] See IRC sec. 36(f)(4)(A).

5

Tax Planning Opportunities With Vacation Homes, Timeshares, and Co-Ownership Arrangements

Introduction

Many clients own vacation homes and timeshares. This chapter provides a brush-up on the tax rules and planning opportunities in this confusing area of the tax law.

"Regular" Vacation Homes (As Opposed to Timeshares and Co-Ownership Deals)

To start, you need to determine which category the vacation home property belongs in. Each category has its own set of tax guidelines and, as a result, its own set of planning opportunities.

Category 1: Rented More Than 14 Days—and Personal Use Exceeds Greater of 14 Days or 10 Percent of Rental Days

Category 1 vacation properties are rented a fair amount of time with substantial personal use as well (personal use includes use by the taxpayer, family members, and anyone else who pays less than fair market rental rates).

For instance, a property that is rented for 30 days and used by family members for a month during the year falls into Category 1. Vacation homes fitting this description are considered personal residences, and they are covered by special Internal Revenue Code (IRC) Section 280A vacation home tax rules:

- Taxpayers can deduct interest up to a total of $1.1 million of mortgage debt for up to 2 personal residences under the IRC Section 163(h) rules for qualified residence interest.
- Property taxes are always deductible, no matter how many homes are owned.

Those fortunate enough to own more than two homes can pick the two with the most mortgage interest each year, which usually are the main residence and the vacation home with the biggest loan. Advise clients with multiple vacation homes to use mortgage financing for one and pay cash for the other(s) to avoid incurring nondeductible interest.

Rental income and expenses for Category 1 homes are handled in the following manner:

- *The first step* is to allocate interest and property taxes between rental and personal usage. For this, count all the time the property was not actually rented as personal.
  - For example, a home is rented 3 months, used by family 2 months, and vacant 7 months. Under these facts, 25 percent (3/12) of the interest and taxes is allocable to the rental period and 75 percent (9/12, which includes unoccupied time) to personal use. The personal part of the interest and taxes (75 percent) shows up on Schedule A as an itemized deduction.
- *The second step* is to reduce the rental income by allocable interest and taxes. If any rental income is leftover, allocable operating expenses, including maintenance, utilities, association fees, insurance, and depreciation, can be deducted, but only to the point at which the remaining income is *zeroed out*. When allocating these operating expenses, consider only the *actual* rental and personal use days.
  - Continuing the example, 60 percent (3/5) of the maintenance, utilities, and so on goes to the rental period, and 40 percent (2/5) goes to personal use. That 40 percent evaporates as a totally nondeductible item. On the client's tax return, use Schedule E (Supplemental Income and Loss) to report 100 percent of the rental income, 25 percent of the interest and taxes, and the allowable operating expenses. In most cases, the bottom line on Schedule E will be 0 because the rental income and allowable expenses will wash.

When all is said and done, this two-step procedure allows the client to fully deduct interest and taxes (part on Schedule A and the rest on Schedule E) and usually enough operating expenses to wipe out any rental income—not a bad deal.

Any disallowed operating expenses are carried over to future years when they can be deducted against rental profits, however, this rarely occurs.

> **Key Point:** The IRS wants taxpayers to allocate both interest and taxes and operating expenses using actual days of occupancy. This results in a greater allocation of interest and taxes to rental usage, which then diminishes the taxpayer's ability to deduct operating expenses. However, two court decisions state that it is permissible to use 365 days and count unused days as personal days for the allocation of interest and taxes while using actual days to allocate operating expenses.[1]

[1] See *D.D. Bolton* (9th Cir. 1982), and *Edith G. McKinney* (10th Cir. 1983).

Category 2: Rented More Than 14 Days—and Personal Use Does Not Exceed Greater of 14 Days or 10 Percent of Rental Days

Category 2 vacation homes fall under the tax rules for rental properties rather than those covering personal residences.

For instance, if a client rents for 210 days and vacations for 21 days during the year, the client has a Category 2 rental property. (Twenty-two days of vacation would put the property back into Category 1.)

Interest, property taxes, and operating expenses should all be allocated based on *actual* usage (21/231 to personal use and 210/231 to rental).

For a Category 2 home, taxpayers are allowed to generate a taxable loss on Schedule E when allocable rental expenses exceed income. However, that loss will typically be covered by the IRC Section 469 passive loss rules for rental real estate. In general, taxpayers can deduct passive losses only to the extent of passive income from other sources (such as rental properties that produce gains).

The $25,000 Exception to the Passive Loss Rules

A favorable exception allows writeoffs of up to $25,000 in passive rental real estate losses for taxpayers who *actively participate* and have adjusted gross income (AGI) under $100,000. Making the property management decisions will get a client over the active participation hurdle. Unfortunately, the $25,000 exception is phased out between AGI of $100,000 and $150,000.

When Average Rental Period Is Seven Days or Less

Unfortunately, the $25,000 exception does not apply when the average rental period is 7 days or less, because the rental is considered a business rather than a rental real estate activity.[2]

Because of this "7-day rule" and the AGI-based phase-out rule for the $25,000 rental real estate exception, many owners in Category 2 find their hoped-for tax losses deferred by the passive loss rules.

Treatment of Mortgage Interest Expense

Another problem is that the interest allocable to personal use (21/231 in the previous example) is nondeductible. Category 2 homes do not qualify as personal residences because the rule allowing an itemized deduction for *qualified residence interest* applies only to mortgage interest on a home meeting the IRC Section 280A(d)(1) definition of a *personal residence*. This requires personal use that exceeds the greater of 14 days or 10 percent of rental days.[3] Homes treated as rental properties fail this test by definition. Therefore, the mortgage interest allocable to personal use is nondeductible personal interest under IRC Section 163(h). (The personal-use portion of property taxes is still deductible on Schedule A.)

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[2] See PLR 9505002; *Walter A. Barniskis*, TC Memo 1999-258; *B. Theodore Chapin*, TC Memo 1996-56; *Steven D. Rapp*, TC Memo 1999-249; and Temp. Reg. 1.469-1T(e)(3)(ii)(A).

[3] Internal Revenue Code (IRC) sec. 163(h)(4)(A)(i)(II).

Tax Planning Implications

From a planning standpoint, this means clients may actually benefit from slipping in some extra vacation days during the year, which can cause the property to drop back into Category 1, allowing interest and taxes to be fully deducted and at which point any remaining rental income can usually be offset by allocable operating expenses.

On the other hand, the client may have plenty of passive income from other sources or have AGI below $100,000 and no problem with the 7-day rule. These circumstances should allow the client to fully deduct the passive loss from the vacation home rental. If the amount of nondeductible personal interest expense will be nominal, the planning suggestion is that the client should minimize vacation days in order to maximize the rental loss.

Category 3: Rented Less Than 15 Days—and Personal Use Exceeds 14 Days

Category 3 vacation homes are also considered personal residences. If there are no rental days, interest and property taxes are deducted on Schedule A, the same as for the primary residence.

If there are some rental days, a unique tax break is available under IRC Section 280A(g). A client need not declare a penny of the rental income. Interest and taxes are still deducted on Schedule A, with no allocation nonsense to worry about. The only negative is that no writeoffs are allowed for operating expenses (depreciation and so on) attributable to the rental period. (This tax law quirk also applies to primary residences, and it is often put to good use during major events, such as the Masters golf tournament.)

More on Tax Planning for Category 2 Vacation Homes

As mentioned, Category 2 properties do not qualify for the $25,000 rental real estate exception to the passive loss rules if the average rental period is 7 days or less. In this case, the *general* passive loss rule applies.

The general rule states that taxpayers can deduct passive losses only to the extent of passive income from other sources *unless* the taxpayer materially participates in the activity.

Two potential solutions to the seven-day rule dilemma are as follows:

1. A taxpayer can try to make sure the vacation property is rented for longer periods. That way, the average rental will exceed 7 days, and the IRS will agree the taxpayer has a rental real estate activity rather than a business. Eligibility for the $25,000 rental real estate exception will be saved.
2. For a taxpayer who cannot avoid running afoul of the seven-day rule, he or she should attempt to materially participate in the business of renting the vacation home. Material participation means there is not a passive activity in the first place, so the client can deduct the vacation home rental losses against all other taxable income.

The easiest ways to prove material participation[4] are to show that the client

- does substantially all the work related to the property (negotiating rentals, collecting the money, performing maintenance, and so on) or
- spends more than 100 hours handling the property and no other person spends more time than that.

In meeting these rules, the client's time and his or her spouse's time can be combined. However, clients typically will not be able to meet either of the material participation standards if they use a management company to handle all the details.

Example 5-1

Leona is ineligible for the $25,000 passive loss exception because her AGI is too high. The result has been suspended passive losses from the vacation home rental activity because there has not been passive income from other sources.

Leona may be able to transform the vacation home rental activity into a *business* by reducing the average rental period to seven days or less. Then, as long as she materially participates, the passive loss rules can be completely avoided and the vacation home losses can be deducted in full against her other income.

Tax Rules for Timeshares and Vacation Home Co-Ownership Arrangements

Inevitably, one of your clients will buy a timeshare or enter into co-ownership arrangement with others to buy a resort condo or cabin. Then, they ask the tax questions. This section will discuss what you need to know to supply the answers.

> **Key Point:** The rules explained in this section apply to both timeshares and vacation home co-ownership arrangements in which several individuals jointly own percentage interests in a vacation home.

No Rental Days

If the client does not rent any of his or her time, the property taxes are deductible on Schedule A.[5] The property tax amount is usually buried in the annual maintenance fee number. The other expenses included in the maintenance fee (for example, insurance, utilities, the homeowners association fee, and actual maintenance expenditures) are nondeductible.

If the timeshare is mortgaged, the interest expense can be deducted as qualified residence interest as long as the other qualified residence interest rules are met.[6] This is because the

[4] See Temp. Reg. 1.469-5T.

[5] IRC sec. 164(a)(1).

[6] IRC sec. 163(h)(4)(A)(iii).

timeshare qualifies as a second personal residence for mortgage interest deduction purposes as long as it is not rented by the owner of that time during the year.

Therefore, the timeshare mortgage interest is deductible, provided the other requirements of IRC Section 163(h) are satisfied (loan secured by the timeshare, no more than $1 million of total residence debt, debt not in excess of fair market value, and so on).

The results are the same for co-ownership situations if the co-owner does not rent any of the time allocated to him or her during the year.

Some Rental Days

If the unit is rented for some or all of the timeshare owner's allotted time, the property is virtually certain to be subject to the IRC Section 280A vacation home rules (the Category 1 rules for *regular* vacation homes explained earlier), because the 14-day or 10 percent test is applied to the unit as a whole by counting the personal-use days of all of the unit's owners during the year.[7]

The total number of personal-use days will generally be high enough to cause the unit to fall into Category 1. The same will likely be true for most vacation home co-ownership arrangements.

Proposed Regulation Section 1.280A-3(f)(5) then requires allocating each timeshare owner's expenses between personal and rental use based on usage by all of the unit's owners during the year. Under this concept, the personal-use and rental percentages will turn out to be the same for all owners of a particular unit.

Unfortunately, it is usually difficult, if not impossible, to obtain usage information from all the owners (there will often be 10 or more different owners). Unless some decent information is available regarding other owners' usage patterns, making the rental or personal allocation based on the individual owner's actual usage meets the spirit if not the letter of the government's rule.

Using some reasonable allocation percentages, the timeshare owner reduces his or her rental income by allocable rental expenses, including allocable interest and property taxes, until rental income is zeroed out on his or her Schedule E.[8] The personal portion of property taxes is then deducted on Schedule A.

Apparently, the personal portion of any mortgage interest expense on the timeshare can be deducted as qualified residence interest only if the individual owner's personal use exceeds the greater of 14 days or 10 percent of his or her rental days, which would qualify the timeshare as a second residence under the definition found in IRC Section 280A(d)(1). Only the individual owner's personal and rental days (and not those of the other owners) are to be considered for this specific purpose.[9]

When the timeshare owner has the right to only 1 or 2 weeks a year, the more than 14 days or 10 percent test is impossible to meet by definition. Therefore, a deduction for the

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7 IRC sec. 280A(d)(2)(A) and Prop. Reg. §1.280A-3(f)(3).

8 Prop. Reg. 1.280A-3(f)(6).

9 Temp. Reg. 1.163-10T(p)(6) and (p)(3)(iii).

personal portion of timeshare mortgage interest will rarely be available under the qualified residence interest rules.

Co-owners of a vacation property are much more likely to meet the more than 14 days or 10 percent test because they are more likely to own at least 3 weeks. If the test is met, they can treat their co-ownership share as a second personal residence and thereby deduct the personal portion of their mortgage interest, as long as the other IRC Section 163(h) rules are met.

Example 5-2

Butch owns weeks 29 and 30 in unit #310 at the Sunny Shores Timeshare Resort. He rents week 29 and uses week 30 personally. His 2 weeks cost a total of $30,000, partly financed by a $20,000 mortgage loan arranged through the developer.

Butch's interest expense is $2,400, and his annual maintenance fees for the 2 weeks total $1,300 ($450 of which is for property taxes). The rental income from week 29 is $1,500. Based on his conversations with other timeshare owners at the gala annual owners' banquet, Butch estimates unit 310 is rented approximately half the year and personally used by the owners for the other half.

Using this information, the Category 1 vacation home rules apply to Butch (and to any other unit 310 owners who rent some of their time as well). Butch's return should show $1,500 of rental income on Schedule E. Allocable rental expenses of up to $1,500 can also be deducted on Schedule E (using 50 percent as the allocation percentage).

Before considering depreciation, allocable rental expenses add up to $1,850 ($1,200 mortgage interest, $225 property taxes, and $425 maintenance fees). On Schedule E, Butch can completely offset his rental income with these expenses, limited to $1,500. The $350 of disallowed cash expenses ($1,850 – $1,500) plus the disallowed depreciation expense carry over to next year.

On Schedule A, Butch deducts the other $225 of property taxes (the 50 percent attributable to personal use), but the $1,200 of personal-use mortgage interest is nondeductible, because Butch does not own enough personal days to pass the more than 14 days or 10 percent test.

Tax-Free Rent Rule

As mentioned in the explanation of Category 3 *regular* vacation homes earlier in this chapter, IRC Section 280A(g) allows the tax-free rental of personal residences for up to 14 days. Unfortunately, few timeshare owners are likely to qualify, because Proposed Regulation Section 1.280A-3(f)(4) states the total rental days during the year for all of the unit's owners must be fewer than 15 in order for any owner to be able to claim tax-free status for his or her rental income.

Even when total rental days are fewer than 15, the individual timeshare owner's personal use must also exceed 14 days or 10 percent of his or her rental days in order for the unit to qualify as a personal residence under the IRC Section 280A(d)(1) definition. (Only personal residences are eligible for the tax-free rent rule.)

In vacation property co-ownership situations, it is somewhat more likely that a co-owner will qualify for the tax-free rent rule, because he or she may have enough personal days to exceed 14 days or 10 percent of his or her rental days. Remember, however, the total rental days of all owners must still be less than 15 for any owner to take advantage of the tax-free rent rule (which is not terribly likely).

Paying the Gain Exclusion Game With Multiple Residences

The basic IRC Section 121 gain exclusion qualification rule is simple: a taxpayer must have owned and used the home as his or her main residence for at least two years out of the five-year period ending on the date of sale.

For married couples, the larger $500,000 exclusion is available as long as one or both spouses satisfy the ownership test and both spouses satisfy the use test.

For taxpayers affluent enough to have one or more vacation residences, some tax-saving games can be played here.

Example 5-3

Biff and Buffy are married and own 3 homes. Their primary home is in Connecticut, and it qualifies for the $500,000 exclusion and could be sold for a $400,000 gain. The couple sells that property tax-free and moves into what was formerly a vacation home in Key West, Florida. Biff and Buffy plan to live there for 2 years, sell the property for an expected $300,000 gain, and exclude that gain, as well. Then they will move into their remaining vacation home in Beaver Creek, Colorado, and live there for 2 years, before selling and excluding the expected gain. Meanwhile, each time they sell a home, they will replace it with another property in the same or different location. Then they can start the *occupy and sell* cycle all over again with the second batch of homes.

Warning: Biff and Buffy need to be aware of the IRC Section 121 gain exclusion qualification rule, explained in the following section, which can potentially negate some of the gain exclusion benefit in this scenario. In addition, they should be sure they understand the state income tax implications before committing to the multiple residence gain exclusion strategy.

Unfavorable Rule for Properties Converted Into Principal Residences After 2008

Before 2009, individuals could convert a former rental property or vacation home into a principal residence, occupy it for at least 2 years, sell it, and take full advantage of the IRC Section 121 home sale gain exclusion privilege ($250,000 maximum exclusion for unmarried individuals; $500,000 maximum exclusion for married joint-filing couples).

Unfortunately, the Housing Assistance Tax Act of 2008 added an unfavorable provision for sales that occur after 2008.[10] The provision makes a portion of the gain from selling an affected residence ineligible for the gain exclusion privilege. The amount of gain that is made ineligible is called the nonexcludable gain, which is calculated as follows.

Step 1: Take the total gain and subtract any unrecaptured IRC Section 1250 gain from depreciation deductions claimed against the property for periods after May 6, 1997.[11]

[10] See IRC sec. 121(b)(4).

[11] This amount of gain cannot be excluded under the IRC Section 121 rules, which has always been the case pursuant to IRC Section 121(d)(6). Instead, this amount of gain must be reported on Schedule D of Form 1040 (U.S. Individual Income Tax Return).

Step 2: Calculate the nonexcludable gain fraction.

The numerator of the fraction is the amount of time *after 2008* during which the property is *not* used as the taxpayer's principal residence. These times are called periods of nonqualified use. However, periods of nonqualified use do not include temporary absences that aggregate to two years or less due to changes of employment, health conditions, or other circumstances to be specified in IRS guidance. Periods of nonqualified use also do not include times when the property is not used as the taxpayer's principal residence if those times are (1) after the last day of use as a principal residence and (2) within the five-year period ending on the sale date.

The denominator of the fraction is the taxpayer's total ownership period for the property.

Step 3: Calculate the nonexcludable gain by multiplying the gain from Step 1 by the nonexcludable gain fraction from Step 2.

The taxpayer must report on Schedule D the nonexcludable gain calculated in Step 3. As mentioned in Step 1, the taxpayer must also report on Schedule D any unrecaptured IRC Section 1250 gain from depreciation for periods after May 6, 1997 (which was not a change). The remaining gain is eligible for the IRC Section 121 gain exclusion privilege, assuming the IRC Section 121 eligibility rules are met.

Example 5-4

Fern (a married joint filer) bought a vacation home on January 1, 2006. On January 1, 2012, she converts the property into a principal residence, and she lives there with her husband for 2012 and 2013. On January 1, 2014, Fern sells the property for a $480,000 gain. Her total ownership period is 8 years (2006–13). The 3 years of post-2008 use as a vacation home (2009–11) result in a nonexcludable gain of $180,000 (3/8 × $480,000). Fern must report the $180,000 as long-term capital gain on her 2014 Schedule D and pay the resulting tax hit. Because she is a joint filer, she can shelter the remaining $300,000 of gain ($480,000 – $180,000) with her $500,000 IRC Section 121 gain exclusion.

Example 5-5

Use the same basic facts as in the previous example, except that now Fern has $10,000 of unrecaptured IRC Section 1250 gain from renting out the property before converting it into a principal residence. Therefore, the total gain on sale is now $490,000. Fern must report the $10,000 of unrecaptured IRC Section 1250 gain on her 2014 Schedule D. She must also report the nonexcludable gain amount of $180,000 (3/8 × [$490,000 – $10,000]) on her 2014 Schedule D. She can shelter the remaining $300,000 of gain ($490,000 – $10,000 – $180,000) with her $500,000 IRC Section 121 gain exclusion.

Example 5-6

Guido (an unmarried person) bought a vacation home on January 1, 2002. On January 1, 2012, he converts the property into a principal residence and lives there for 2012 and 2013. On January 1, 2014, he sells the property for a $400,000 gain. Guido's total ownership period is 12 years (2002–13). The 3 years of post-2008 use as a vacation home (2009–11) result in a nonexcludable gain of $100,000 (3/12 × $400,000).

Guido can claim the $250,000 IRC Section 121 gain exclusion. Ignoring the nonexcludable gain rule, he must report a $150,000 gain on his 2014 Schedule D ($400,000 – $250,000). Because the $150,000 gain that he must report anyway exceeds the $100,000 nonexcludable gain, the nonexcludable gain rule has no impact in this particular case.

Example 5-7

However, if Guido has only a $200,000 gain when he sells the property on January 1, 2014, he now has a nonexcludable gain of $50,000 (3/12 × $200,000) which he must report on his 2014 Schedule D. He can use his $250,000 IRC Section 121 gain exclusion to shelter the remaining $150,000 of gain ($200,000 – $50,000).

> **Key Point:** Comparing the results in examples 5-6 and 5-7 reveals the interesting truth that the nonexcludable gain rule can hurt sellers with smaller gains while having absolutely no impact on those with larger gains.

Example 5-8

Hermione (a married joint filer) bought a vacation home on January 1, 2006. On January 1, 2012, she converts the property into a principal residence and lives there with her husband for 2012 and 2013. She then converts the home back into a vacation property and uses it as such for 2014 and 2015. Hermione then sells the property on January 1, 2016, for a $520,000 gain. Her total ownership period is 10 years (2006–15). The first 3 years of post-2008 use as a vacation home (2009–11) result in a nonexcludable gain of $156,000 (3/10 × $520,000). Hermione must report the $156,000 as long-term capital gain on her 2016 Schedule D. Because she is eligible for the $500,000 IRC Section 121 gain exclusion, she can completely exclude the remaining $364,000 of gain ($520,000 – $156,000) with her exclusion.

Key Point: Notice that the last 2 years of use as a vacation home (2014–15) *do not* count as periods of nonqualified use because they occur (1) after the last day of use as a principal residence and (2) within the 5-year period ending on the sale date. Therefore, using the property as a vacation home in 2014 and 2015 does not make the nonexcludable gain any bigger.

6

Tax Planning for Marital Splits

Introduction

Statistics show a large percentage of marriages eventually end in divorce. During tough economic times, divorces may be even more common. The obvious emotional and financial toll on divorcing clients can be heavy. Unfortunately, without thoughtful tax planning, it is quite likely that unexpected tax liabilities will add to client woes.

Tax advisers can render valuable service by helping divorcing clients understand and plan for the federal tax implications associated with marital dissolutions. Experience shows that this can be a challenging situation for advisers. Although some divorcing clients are able to maintain decent relations with the other party and behave reasonably in resolving financial and tax issues, this is the situation in only a limited percentage of cases. Often it will be found that the client is overwrought, hostile toward the soon-to-be ex-mate, and generally somewhat irrational. As a result, the client may be disinclined to consider the long-range tax implications that will result from how the divorce is structured and may be especially disinclined to do anything that even hints of cooperation with the other party.

As a further potential complication, divorce attorneys are sometimes unfamiliar with the fine details of the tax law, although they may not always admit this lack of expertise. As the remainder of this chapter will show, most postdivorce tax consequences will be determined by the language in the divorce papers, and few tax problems can be "fixed" after the documents have been signed.

Therefore, it is critical for the tax adviser to become involved in the divorce negotiation process *before* the language in the final decree and property settlement has been cast in stone. It is also essential to gain the cooperation and respect of the divorce attorney so that documents can be reviewed and tax planning suggestions implemented before the divorce is a "done deal."

Finally, there are important tax implications to consider before clients decide to become divorced, that is, at the point at which they have separated or are strongly considering separation.

Separate Versus Joint Returns for Pre-Divorce Years

For federal income tax purposes, individuals are generally considered married until they are legally separated under a decree of divorce or separate maintenance.[1] Couples who are simply *separated* in the sense of physically living apart are still married.

Marital status for a tax year depends on whether the client is married or divorced as of December 31. In other words, a couple cannot file as married for the portion of the year they are still married and as single for the period after the divorce through the end of the year. They are treated as either married or single for the entire year.

This rule often means the client is divorced or about to be divorced now but was still married as of the end of *last year*. Therefore, the filing status for the preceding year may still be unresolved. Of course, if the divorce will not occur until *next year*, this year's filing status is the issue.

A couple that is still married at the end of the year in question (whether *this year* or *last year*) generally has the option of filing jointly or using married filing separate (MFS) status for federal income tax returns. Most married couples form the habit of filing jointly to save the time and expense of filing two returns and maintaining two sets of records. Filing jointly also saves on taxes when one spouse has relatively high income and the other has little or none, because the joint rate brackets are more favorable than those for single filers.

Some key points to consider for separate vs. joint returns are:

- Depending on state domestic relations law, it may be possible to obtain a decree of separate maintenance in advance of the actual final divorce decree.
- If a decree of separate maintenance is obtained before year-end, the couple is considered legally separated (same as divorced for tax purposes) for that year.[2] Then, the individuals must file as single taxpayers. However, favorable head of household filing status may be available to one or both.
- Obtaining a decree of separate maintenance before year-end will have the same *year-end tax planning effect* as getting *officially* divorced before year-end.

Marriage Penalty Relief

It is often perceived as unfair that individuals can be forced into federal income higher tax brackets just because they are married. Although the second phase of the Bush tax cut legislation enacted in 2003 did not completely eliminate the so-called marriage penalty, it succeeded in delivering meaningful tax savings to joint filers. It also helps married persons who file separately from their spouses, which was another long-overdue improvement. Through

[1] Internal Revenue Code (IRC) sec. 7703(a)

[2] IRC sec. 7703(a).

2012, marriage penalty relief comes in the form of expanded 15 percent rate brackets and larger standard deduction amounts, including the following:

- The 10 percent and 15 percent tax rate brackets for *joint filers* are exactly twice as wide as those for singles. The joint-filer 15 percent bracket for 2012 tops out at taxable income of $70,700. However, the higher rate brackets (25 percent and up) are still not twice as wide as those for singles. Therefore, the marriage penalty can still come into play for higher-income joint filers.
- The standard deduction for *joint filers* is exactly double the amount for singles. The 2012 joint-filer standard deduction is $11,900.

> **Sunset Rule:** As the tax law currently reads, these marriage penalty relief provisions will only last through 2012. However, the author's best guess is that these provisions will be kept in place after 2012.

- The 10 percent and 15 percent tax rate brackets for *married filing separate* status are the same as for singles. The married-filing-separate 15 percent bracket for 2012 tops out at taxable income of $35,350. However, the higher rate brackets (25 percent and up) remain narrower for married filing separate status than for single filers. Therefore, married filing separate status continues to be unfavorable (compared to single-filer status) for higher-income individuals.
- The standard deduction for married filing separate status is the same as for singles. The 2012 married-filing-separate standard deduction is $5,950.

> **Sunset Rule:** As the tax law currently reads, these marriage penalty relief provisions will only last through 2012.

Filing Separately to Avoid Liability for Ex-Spouse's Tax "Mistakes"

For the year (or years) preceding a divorce, it is often inadvisable for clients to file a joint return because of the issue of legal liability for federal income taxes. Instead, MFS may be best.

When a joint return is filed, both spouses are jointly and severally liable for any unpaid or understated federal income taxes relating to that year.[3] In other words, the IRS can determine that there is a tax deficiency for a joint return year and attempt to collect 100 percent of the amount due from *either* spouse, regardless of which individual actually caused the problem by understating income or overstating deductions.

In contrast, when MFS status is used, each spouse is liable only for the income tax that is shown (or should have been shown) on that spouse's separate return. Therefore, MFS is advisable when a taxpayer has any suspicions that the spouse might fail to report income or pay in the required taxes.

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[3] IRC sec. 6013(d)(3)

The joint-and-several-liability rule can be avoided to the extent the client qualifies for so-called innocent spouse relief under Internal Revenue Code (IRC) Section 6015, as explained later in this section. However, the innocent spouse rules—when they apply—only repair damage that has already been done. It is usually better to avoid the problem in the first place by filing separate returns.

Some key points to consider for filing separately to avoid liability:

- In pre-divorce situations, one spouse is often tempted to hide income from the other, and financial resources are generally strained because the couple is living apart and incurring higher expenses.
- Therefore, the stage is set for tax problems due to under reported income, failure to pay in taxes, or both.
- This can happen even when both spouses have previously demonstrated financial responsibility and compliance with the income tax system.

Tax Impact of Filing Separate Returns

The division of a married couple's income and deductions when they file separate returns is a matter of state law. The most important factor is whether they live in a community property state. (The nine community property states are California, Texas, Washington, Arizona, Wisconsin, Nevada, Louisiana, New Mexico, and Idaho.)

Generally, in noncommunity property states, each spouse reports the income he or she earns and claims deductions for amounts he or she pays. Federal income taxes withheld from a spouse's earnings are allocated to that spouse.4 Presumably, the same is true for estimated tax payments that are made separately with respect to income earned by a spouse. Joint estimated tax payments can be allocated in any manner agreed to by the spouses. If they cannot agree, joint estimated payments will be allocated in proportion to each spouse's separate-return tax liability.[5]

If the spouses (1) are separated under a written separation agreement or (2) live apart at all times during the last six months of the year, the custodial spouse is entitled to the child dependent exemption deduction, regardless of who actually pays for the child's living expenses. The custodial spouse is the one who has custody of the child for the greater portion of the calendar year. However, by releasing the exemption on Form 8332 (Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent), the custodial spouse can instead agree to let the other spouse take the deduction.[6]

In noncommunity-property states, the higher-earning spouse will often pressure the lower-earning spouse to file jointly, because that would lower the required tax payments for the higher-earning spouse.

[4] Temp. Reg. 1.31-1.

[5] Rev. Ruls. 80-7, 1980-1 CB 296, and 85-70, 1985-1 CB 361.

[6] See IRC sec. 152(e)(1) and (2).

Example 6-1

Married Filing Separate Versus Joint Return

Hubster and Wifester are separated pending a divorce which will soon become final. In 2011, Hubster earned $95,000 from his employment. Wifester has mostly worked in the home taking care of the 2 kids. She had $10,000 of income from a part-time job. Hubster wants to file a joint return for 2011. The standard deduction will be taken.

Hubster and Wifester live in a state where the person earning the income owes the taxes when MFS status is used, and Hubster is entitled to the personal exemptions for the children.

The tax results of joint and MFS filings are as follows (2011 rates):

	Joint Return	MFS Returns	
		Hubster	Wifester
Income	$105,000	$95,000	$10,000
Standard deduction	(11,600)	(5,800)	(5,800)
Personal exemptions	(14,800)	(11,100)	(3,700)
Taxable income	78,600	78,100	500
Tax liability	$11,900	$15,903	$50

In this example, you can clearly see why Hubster wants to file jointly. Through his employment, he had $12,000 of federal income tax (FIT) withheld for the preceding year. This amount will be credited toward his separate liability if he uses MFS. If he is forced to use MFS, he will still owe $3,903. Therefore, Hubster would be well-advised to offer to pay the entire $11,900 liability if Wifester agrees to file jointly.

Wifester, on the other hand, should agree to a joint return only if she is confident the return will properly reflect all income and deduction items and that the tax liability shown on the return has been or will be paid by Hubster. (Wifester would be well-advised to insist on engaging a professional to prepare the return.)

If Wifester agrees to a joint return using the numbers shown in this example, and it turns out Hubster paid in only $5,000 for the year, Wifester will be jointly and severally liable for the resulting $6,900 tax deficiency. This will be the case even if the two are divorced by the time the IRS determines there was a deficiency for the earlier year. As explained later in this chapter, Wifester will probably qualify for innocent spouse relief, but that will involve a lot of hassle.

If Wifester insists on filing separately and Hubster pays in only $5,000 for the year, Wifester will *not* be liable for the resulting tax deficiency. Instead, she is liable only for the $50 tax liability shown on her separate return.

Strategy 6-1

Obviously, if you are representing the higher-earning spouse in a situation similar to example 6-1, you would advise your client to obtain the spouse's permission to file jointly. Of course, you would also advise the client to file an accurate return and pay the tax. There is nothing wrong with joint filings when both spouses behave responsibly. Unfortunately, in divorce situations, individuals may act differently than they normally would.

Strategy 6-2

From a MFS tax-planning perspective, it may be advisable to have the higher-earning spouse agree to pay for tax deductible expense items (such as mortgage interest and property taxes). Although the spouses are not getting along, they are still best served by taking action to minimize their combined tax liabilities. Similarly, when custody arrangements mean the higher-earning spouse does not qualify for dependent exemption deductions for the children,[7] it may be advisable for the other spouse to agree to release the exemptions to the higher-earning spouse by filing Form 8332.

As opposed to using joint filing status (or head of household filing status, which is discussed later in this section), there are some definite disadvantages to using MFS status. For example, a taxpayer who uses MFS status

- cannot make a Roth IRA contribution if his or her adjusted gross income (AGI) exceeds $10,000;[8]
- cannot claim the child and dependent care credit;[9]
- cannot claim either of the higher education tax credits;[10]
- cannot claim the college loan interest writeoff;[11]
- cannot claim the deduction for college tuition and related expenses;[12]
- cannot deduct more than $1,500 of net capital losses;[13] and
- must itemize deductions if the other spouse itemizes, even if using the standard deduction would be better for one.[14]

In many cases, the "liability protection" benefits of using MFS status must be balanced against the loss of some current-year tax breaks that would be available if a joint return is filed.

Filing Separately in Community Property States

The preceding discussion of MFS tax consequences assumes the spouses do not reside in one of the nine community property states (California, Texas, Washington, Arizona, Wisconsin, Nevada, Louisiana, New Mexico, and Idaho).

In community property states, married couples are generally required to split most income, deductions, and credit for tax payments 50/50 for federal income tax purposes. (The rules regarding who gets children's dependent exemption deductions are the same whether or not the couple resides in a community property state.)

Therefore, unlike in example 6-1, there may not be meaningful tax savings from filing jointly versus MFS for residents of community property states.[15] That being said, it is always

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[7] See IRC sec. 152(e).

[8] IRC sec. 408A(c)(3)(A).

[9] IRC sec. 21(e)(2).

[10] IRC sec. 25A(g)(6).

[11] IRC sec. 221(f)(2).

[12] IRC sec. 222(d)(4).

[13] IRC sec. 1211(b)(1).

[14] IRC sec. 63(c)(6)(A).

[15] See IRS Publication 555, *Community Property*.

a good practice to "run the numbers" just to make sure particularly if either spouse has a significant amount of property that generates income.

Strategy 6-3

If joint and MFS returns result in approximately the same total tax liability, there is generally little reason *not* to file separate returns. Filing separately protects each spouse from tax liabilities caused by the other's actions.

Favorable Community Property Rule May Apply

When a couple lives apart for the *entire* year but is still married at year-end, a favorable special rule provided by IRC Section 66 can come into play. When applicable, the IRC Section 66 rule overrides the usual rule that most items are shared 50/50 for federal income tax purposes when separate returns are filed by spouses residing in community property states. The IRC Section 66 rule is basically intended to ensure that the spouse who gets the money from taxable community income owes the tax when community income is *not* actually shared 50/50.

IRC Section 66 Rule

The IRC Section 66 rule prevents the obviously undesirable situation of one spouse having to report and pay tax on income that he or she never sees. If such a situation were allowed to exist, an estranged spouse could effectively be forced to file a joint return (with resulting possible exposure to tax "sins" of the other spouse) in order to avoid a large separate return tax liability. For the IRC Section 66 rule to apply, *all* four of the following conditions must be met for the tax year in question:

- The individuals are married at year-end but lived apart for the entire year.
- A joint return is not filed for the year.
- One or both of the individuals had earned income for the year that is community income (that is, income that would be shared 50/50 under the general rule).
- There were no transfers of such earned community income between the individuals. However, per IRS Publication 555, *Community Property*, small transfers can be disregarded. Also, transfers or payments to or for a dependent child (such as court-ordered pre-divorce temporary child support payments to the other spouse) will not violate this rule. Transfers or payments to or for a dependent child will not violate this rule even if they satisfy a support obligation of the other spouse.[16]

If all the IRC Section 66 requirements are met, each spouse *must* report *all* community income on his or her separate tax return pursuant to the following rules as set forth in IRC Section 879(a):

- Income from performing services or carrying on a trade or business (other than a partnership) is reported by the spouse performing the services or conducting the trade or business.

[16] IRS Publication 555.

- Partnership income is reported by the spouse who is the partner.
- Taxable Social Security benefits are reported by the spouse who receives the benefits (per IRS Publication 555).
- To the extent income from separate property is considered community income (it is in some states), the income is reported by the spouse who owns the property.
- All other community income (interest, dividends, and so on) is reported by the spouses as such income is considered to be shared according to state community property law.

Key Point: If the IRC §Section 879(a) requirements are not met by a married couple and they file separate returns, they generally must report all taxable community income on their respective returns according to how it is considered shared under state community property law (normally 50/50).

Filing Separately as Head of Household

Before a final decision regarding filing joint or separate returns is made, determine if the divorcing client can file as a head of household (HOH). In many cases, spouses with pre-divorce primary custody of a child will turn out to be eligible.

Assessing HOH eligibility is important because the tax rates and standard deduction for HOH status are more favorable than those for MFS. For 2012, the 25 percent bracket starts at taxable income of $47,350 for HOH versus $35,350 for MFS; the HOH standard deduction is $8,700 versus $5,950 for MFS.

As is the case with MFS returns, HOH returns are considered separate returns. Therefore, they *protect* one spouse from tax liabilities caused by the other's actions. Also, the preceding discussion of how income, deductions, tax payments, and children's personal exemption deductions are allocated in MFS situations also applies when one spouse (or both) files using HOH status.

There are several other benefits of HOH filing status compared to MFS filing status. For instance, an MFS filer cannot (1) make a Roth IRA contribution if his or her AGI exceeds $10,000, (2) take the child and dependent care credit, (3) claim either of the college tuition tax credits or the deduction for college tuition and related expenses, (4) claim the college loan interest writeoff, or (5) deduct more than $1,500 of net capital losses. Also, the AGI-based phase-out ranges for various tax benefits are lower for MFS filers than for HOH filers. For all these reasons, HOH status is almost always much preferable to MFS status.

Abandoned Spouse Rule

The general rule is that HOH status is available only to unmarried taxpayers. However, there is an exception—the so-called abandoned spouse rule—for married individuals who can meet all of the following conditions:[17]

- Separate returns are filed.
- The taxpayer lived apart from the spouse during the last six months of the year.

[17] IRC secs. 2(b), 2(c), 151, 152, and 7703(b).

- The taxpayer's home served for more than half the year as the principal home of the taxpayer's qualifying child, for whom a personal exemption deduction is allowed (even if the exemption is allocated to the other spouse with Form 8332).
- The taxpayer paid more than half the cost of maintaining the home for the year (rent, mortgage interest, property taxes, insurance on the home, utilities, food eaten in the home, and so on, but *not* counting other "living expenses," such as clothing, medical care, schooling, transportation, vacations, and so on).

If a spouse meets the abandoned spouse rule conditions, the spouse is treated as *unmarried* for the year and eligible for HOH status. The other spouse must then use MFS or HOH status. (HOH is available for the other spouse if that spouse also meets the four requirements listed previously; for example, when each spouse has primary custody of at least one child during the pre-divorce period and they live apart for the last six months of the year.)

Children's Dependent Exemptions and HOH Status

As stated earlier in this chapter, when the spouses live apart at all times during the last six months of the year, the custodial spouse is entitled to the child's dependent exemption deduction—regardless of who actually pays for the child's living expenses.[18] The custodial spouse is the one who has custody of the child for the greater portion of the calendar year.

Because of the third condition listed previously in the section "Abandoned Spouse Rule" in this chapter, HOH status and the dependent exemption deduction for the child who "qualifies" the parent for HOH status almost always go hand in hand. However, by releasing the exemption on Form 8332, the custodial spouse can instead agree to let the other spouse take the deduction.[19] Releasing the exemption does *not* affect the ability to qualify for HOH status.

> **Key Point:** Being entitled to a child dependent exemption deduction does not automatically mean HOH status is available. All four of the conditions listed previously in the section "Abandoned Spouse Rule" in this chapter must be met.

Example 6-2

Spouse Qualifies for HOH Status

Hubster and Wifester are separated pending a soon to be final divorce. In 2011, Hubster earned $60,000 from his employment and had $7,000 of FIT withheld from his salary. Wifester earned $45,000 and had $6,000 of FIT withheld. The couple lived in separate residences from June 1 through year-end. Pursuant to a court-ordered pre-divorce joint child custody and visitation agreement, Wifester had primary custody over the 2 kids after separate residences were established. During this period, Hubster had weekend visitation rights and was required to pay temporary child support of $1,000 per month.

Hubster and Wifester live in a state where the spouse earning the income owes the taxes when separate returns are filed. For simplicity, the standard deduction will be taken.

[18] IRC sec. 152(e).

[19] See IRC sec. 152(e)(1) and (2).

Based on these facts, Wifester qualifies for HOH filing status for 2011 (because her home served as the children's principal home for more than half the preceding year), even though she was still legally married at year-end. Notwithstanding the temporary child support payments made by Hubster, Wifester is also entitled to the personal exemption deductions for both children. She qualifies as the custodial parent for the preceding year because the kids spent more than half the year under her custody.[20]

If Wifester chooses to file a separate return using HOH status, Hubster would have to file using MFS status. Alternatively, they could file a joint return.

The tax results of the filing status options are shown as follows (2011 rates):

	Joint Return	Hubster (MFS)	Wifester (HOH)
Income	$105,000	$60,000	$45,000
Standard deduction	(11,600)	(5,800)	(8,500)
Personal exemptions	(14,800)	(3,700)	(11,100)
Taxable income	78,600	50,500	25,400
Tax liability	$11,900	$8,750	$3,203

Hubster wants to file jointly because that would result in a $1,100 refund ($13,000 in withholdings less $11,900 joint tax liability), which he proposes to split 50/50 with Wifester. In contrast, if separate returns are filed, Hubster would owe $1,750 ($8,750 MFS liability less $7,000 withheld from his salary).

Wifester should be advised to file a separate HOH return. She would obtain a $2,797 refund ($6,000 in withholdings less her $3,203 HOH tax liability) *and* she would be protected from any exposure to tax liability resulting from Hubster's actions (such as his failing to report income or overstating deductions for the preceding year).

In fact, there is really no reason to file a joint return in this example, because the combined separate return liabilities are barely more than the joint return liability ($11,900 joint return liability versus $11,953 combined separate return liabilities). Wifester should be advised to consider giving $1,750 of her refund to Hubster if that is necessary to convince him to file separately without any argument (to compensate Hubby for the $1,750 that he will owe the IRS if he files separately). Alternatively, she could be encouraged to agree to release one or both of the personal exemption deductions for the children to Hubster for the year. This is done using Form 8332 and would reduce or eliminate Hubster's unpaid tax liability while decreasing Wifester's refund.

Key Point: If Hubster had primary custody of one child from June 1 through year-end while Wifester had primary custody of the other, *both* spouses would qualify for HOH status under the abandoned spouse exception.

Other Ways to Avoid Tax Liabilities Caused by Spouses

The surest way for one spouse to avoid tax liabilities caused by the other is to simply file separate returns for pre-divorce tax years. As discussed earlier in this chapter, both MFS and HOH returns will do the trick.

[20] See sec. 152(c) and (e).

However, in the interest of being able to offer other alternatives to divorcing clients, consider the following additional options for protecting an *innocent* spouse from liability for tax problems caused by a *guilty* spouse.

Decree of Separate Maintenance before Year-End

As mentioned earlier in this chapter, some state domestic relations statutes allow individuals to obtain a decree of separate maintenance in advance of the final divorce decree. If a decree of separate maintenance is obtained before year-end, the couple is considered legally separated—same as divorced for tax purposes—for that year.[21] Legally separated individuals cannot file joint returns. Instead, they must file as single taxpayers (unless they remarry before year-end).

Thus, legal separation before year-end allows an *innocent* spouse to avoid a joint return without having to use the relatively unfavorable MFS filing status. After legal separation, the relatively favorable single filing status is a given, and the even more favorable head of household filing status may be available.

Tax Liability Indemnification Clause in Divorce Agreement

Including a tax liability indemnification clause in the divorce document means one ex-spouse is legally entitled to be reimbursed if that spouse is forced to pay a tax liability caused by the actions (or inactions) of the other. Such a clause will *not* avoid joint and several liability with respect to unpaid taxes for joint filing years. The IRS can still enforce collection efforts against either ex-spouse (unless the innocent spouse rules apply). The indemnification clause simply gives a spouse who wrongly gets *stuck with the bill* legal recourse against the other ex-spouse.

Unfortunately, if the IRS is having trouble collecting from the *guilty* ex-spouse, it is unlikely that an indemnification clause will do the *innocent* ex-spouse much good. Still, it cannot hurt to include one in the divorce decree, especially with respect to unknown or undisclosed tax liabilities for open joint filing years before marital discord became an issue.

Innocent Spouse Rules

Under former IRC Section 6013(e), *innocent spouses* could under limited circumstances avoid joint and several liability. However, this apparent relief was often unavailable because of the statutory language and IRS insistence on an exceedingly strict interpretation of said language. The longstanding problem was finally addressed with the enactment of new IRC Section 6015, which contains *new and improved* innocent spouse rules.

> **Warning:** New IRC Section 6015 does not repeal the joint-and-several-liability rule. As before, the general rule is *spouses and former spouses are jointly and severally liable for taxes from years for which joint returns are filed.* New IRC Section 6015 greatly increases the odds of qualifying for innocent spouse relief from the joint-and-several-liability rule. However, as under prior law, the only *surefire* way to avoid joint and several liability is by *not* filing a joint return.

[21] IRC sec. 7703(a).

New IRC Section 6015(b) provides general elective relief to *all* joint filers, including those still married to the individual with whom a joint return was filed. Relief is available to electing individuals when there is a tax understatement attributable to *erroneous items* caused by the spouse or former spouse (the other party to the joint return) and the electing individual establishes all of the following:

- He or she did not know of the understatement.
- He or she had no reason to know of the understatement.
- It would be unfair to hold him or her responsible for the understatement after considering all the facts and circumstances.

If the electing individual knew there were some tax problems, but did not know about their full extent, he or she can still make the IRC Section 6015(b) election and get off the hook for the unknown part of the tax understatement.[22]

> **Observation:** Relief under this election might be tougher to qualify for than it first appears. Basically, the electing individual must be in the dark about the tax problem or at least the full extent of the problem in order to pass the did-not-know part of the test. And the electing individual generally *cannot* simply plead ignorance of the problem without failing the did-not-have-any-reason-to-know part of the test. Thus, to qualify for this election, the individual must be innocent and not be ignorant. In real-life circumstances, this will rarely be the case.

The IRC Section 6015(b) election has no impact on the liability of either spouse for any understatement caused by his or her own actions or omissions. The effect of the election is simply that the electing individual is protected from liabilities caused by the other party's actions or omissions.

"Ignorant Spouse" Relief

New IRC Section 6015(c) provides another form of elective relief for joint filers who, at the time the election is filed, (1) are divorced or legally separated from the other party or (2) have lived apart for the preceding 12 months from the other party.

Under this second election, the liability of the electing individual for a joint-return year cannot exceed the *separate liability* of that person. The separate liability of each joint filer is determined by allocating income and deduction amounts as if separate returns were filed.[23]

However, the election is unavailable with respect to tax understatements—or portions thereof—caused by the other party about which the electing individual had *actual knowledge* at the time the joint return was signed. In other words, if the electing individual had actual knowledge of an understatement, that amount remains subject to the joint-and-several-liability rule.

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[22] IRC sec. 6015(b)(2).

[23] IRC sec. 6015(d).

The actual-knowledge standard is intended to be much looser than the did-not-know-and-had-no-reason-to-know standard that must be met to qualify for the IRC Section 6015(b) election explained previously. In other words, *ignorance* of tax problems is enough to qualify for the IRC Section 6015(c) election, under the did-not-have-actual-knowledge test.

> **Warning:** The IRC Section 6015(c) election has no impact on the liability of either spouse for any understatement caused by his or her own actions or omissions. The effect of the election is simply that the electing individual is protected from liabilities caused by the other party's actions or omissions.

Equitable Relief

In the IRS Restructuring and Reform Act of 1998, the U.S. Congress directed Treasury to develop rules granting administrative relief to joint filers who fail to qualify for relief under the preceding rules when all facts and circumstances indicate it's unfair to enforce joint and several liability.[24] Revenue Procedure 2003-61 supplies the procedures to request equitable relief.

Procedures

Form 8857 (Request for Innocent Spouse Relief) is used to take advantage of all three forms of relief explained previously. Both the IRC Section 6015(b) election (*innocent spouse relief*) and the IRC Section 6015(c) election (*ignorant spouse relief*) must be made (using Form 8857) within two years after IRS collection activity against the electing individual has commenced for amounts related to a joint-return year.

Timing of the Divorce—This Year or Next?

If it appears likely the divorce will (or could) become final near the end of the current year, tax planning considerations may dictate whether it is best to effect the marital dissolution before year-end or, instead, early in the following year. If the divorce is finalized before year-end, the two ex-spouses can—and must—file using single or HOH status for that year (unless of course there is a remarriage before year-end).

Because of the unfavorable federal income tax rate structure that applies to some married individuals (the so-called marriage penalty), finalizing the divorce before year-end may result in a lower combined tax liability for the two parties. This outcome is highly likely when both have significant taxable income. In such cases, the parties should consider *planning* for the divorce to take place before year-end. They should agree in the divorce decree on some allocation of the resulting tax refund.

[24] IRC sec. 6015(f).

Strategy 6-4

Depending on state domestic relations laws, it may be possible to obtain a decree of separate maintenance before year-end when it is not possible to obtain a final divorce decree by that date. If a decree of separate maintenance is obtained before year-end, the couple is considered legally separated for that year, which is the same as divorced for federal income tax purposes.[25] This will be beneficial in cases in which ending the marriage before year-end allows the individuals to file as single taxpayers and thereby avoid the marriage penalty for that year.

Allocations of Taxable Income, Deductions, and Tax Payments

Still Married at Year-End

If the couple stays married through year-end, they can generally file using either joint or MFS status. HOH filing status may also be available to one or both spouses, as discussed earlier in this chapter.

Pre-divorce Allocations When Divorced at Year-End

If the couple divorces before year-end (or is treated as divorced because a decree of separate maintenance is in effect), the allocations of income, deductions, and tax payments for the pre-divorce period of the year will follow the *separate return rules* summarized earlier in this chapter.

Postdivorce Allocations

For the postdivorce period of the year, each ex-spouse simply reports his or her income and claims deductions for amounts he or she pays.

Children's Dependent Exemption Deductions in Year of Divorce

In addition to the usual rules regarding eligibility for children's dependent exemption deductions, a special rule applies to children of divorced parents (including those who are legally separated under a decree of separate maintenance). The dependent exemption *automatically* belongs to the parent (ex-spouse) who has custody of the child for the greater part of the calendar year.[26] This parent is termed the *custodial parent*.

The custodial parent's right to the dependent exemption is unaffected by how much child support the noncustodial parent may pay. However, as discussed later in this chapter, the custodial parent can voluntarily release the dependent exemption to the noncustodial parent by signing Form 8332.[27] This may be advisable for tax planning reasons when the noncustodial parent is in a higher marginal tax bracket.

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[25] IRC sec. 7703(a).

[26] IRC sec. 152(e).

[27] IRC sec. 152(e)(2).

HOH Status in Year of Divorce

For the year of the divorce, and later years as well, favorable HOH tax filing status is often available to one ex-spouse, and sometimes to both. The issue of HOH availability is important, because it can result in a significant reduction in the combined tax liabilities of the estranged couple. When this is the case, the parties should consider attempting to accelerate the divorce process so that it occurs before year-end.

Some key points to consider for HOH status in year of divorce are:

- After a couple is divorced, or legally separated under a decree of separate maintenance, the HOH eligibility rules are more liberal than those for individuals who are still married at year-end.
- In the year of divorce and later years, HOH status is available if both of the following requirements are met:[28]
  - — The taxpayer is single at year-end and maintains a home that constitutes the principal residence for more than half the year of his or her qualifying child.
  - — The child resides in the same household as the taxpayer during the *more than half the year* qualification period.

In other words, the taxpayer must be the custodial parent in divorce situations.

Maintaining the home means paying more than half the cost of running the household for the year in question.

The taxpayer need not be entitled to a dependent exemption deduction for the child. Releasing a child's dependent exemption to the noncustodial parent (ex-spouse) via Form 8332 will not disqualify the custodial parent from HOH status.

A few cautionary items to consider:

- A divorced parent can qualify for a dependent exemption deduction simply by having custody of the child for a greater part of the year than the other parent.[29]
- However, the HOH eligibility rules require having the child in the parent's household for more than *six months* and paying more than half the cost of maintaining the household.[30]
- In other words, having the dependent exemption does not automatically equate to meeting the HOH rules.

Despite the preceding warnings:

- It usually turns out that an ex-spouse who is single and a custodial parent *will* qualify for HOH status.
- If there are several children, each ex-spouse can qualify if each is a custodial parent and each meets the more-than-six-months rule.
  - — This can happen, for example, when a younger child *goes with Mom* and an older child *goes with Dad*.

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[28] IRC sec. 2(b).

[29] IRC sec. 152(e).

[30] IRC sec. 2(b).

Divorcing Before Year-End to Avoid Marriage Penalty

The following example illustrates the fairly typical situation in which divorcing before year-end saves on taxes because the marriage penalty is then avoided for that year. Remember that obtaining a decree of separate maintenance before year-end is the same as obtaining a final divorce decree for federal income tax purposes.

Example 6-3

Divorce Before Year-End

Hubster and Wifester are contemplating whether they should attempt to finalize their divorce this year or let it slide until early next year. In 2011, Hubster will earn $155,000 from his employment and have $32,000 of FIT withheld from his salary. Wifester will earn $45,000 and have $6,000 of FIT withheld. The couple lived in separate residences from June 1 through year-end. Pursuant to a court-ordered pre-divorce joint child custody and visitation agreement, Wifester was given primary custody over the 2 kids after separate residences were established. During this period, Hubster had weekend visitation rights and was required to pay temporary child support of $1,000 per month.

Hubster and Wifester live in an equitable distribution state where pre-divorce taxable earnings and related tax withholdings are allocated to the spouse earning the income. For simplicity, the standard deduction will be taken.

Based on these facts, Wifester will qualify for HOH filing status (because her home served as the children's principal home for more than half the year) whether or not she is married at year-end (see earlier in this chapter for the pre-divorce HOH eligibility rules). Notwithstanding the temporary child support payments made by Hubster, Wifester is also entitled to the personal exemption deductions for both children whether or not the divorce is final by year-end (she qualifies as the custodial parent for the year because the kids spent more than half the year under her custody).

If the couple remains married through year-end and Wifester files using HOH status, Hubster must use MFS status. Alternatively, the couple could divorce by year-end, which would allow Hubster to file as a single taxpayer. As explained, this would not affect Wifester's filing status, as she can file using HOH with or without the divorce. The tax results of a divorce before year-end are shown as follows (2011 rates):

	Hubster (single)	Wifester (HOH)
Income	$155,000	$45,000
Standard deduction	(5,800)	(8,500)
Personal exemptions	(3,700)	(11,100)
Taxable income	$145,500	$25,400
Tax liability	$34,357	$3,203
Amount owed (refund)	$2,357	$(2,797)

Compared with the tax results from staying married and filing separate returns for the year, Wifester is in the same position regardless, assuming she files a separate HOH return if the divorce is not finalized by year-end. However, Hubster would be considerably better off by getting divorced by year-end and filing using single taxpayer status. He would owe $4,742 if he is forced to use MFS status (liability of $36,742 versus $32,000 withheld) compared to only $2,357 if the divorce occurs before year-end and he files as a single person (liability of $34,357 versus $32,000 withheld). Because Wifester *should* file a separate return

for the reasons explained earlier in this example, the couple should be advised to attempt to make the divorce final before year-end (or at least obtain a decree of separate maintenance if allowed in their state).

If necessary to facilitate a quicker settlement, Wifester should be advised to consider agreeing in the divorce decree to give part of her tax refund to Hubster. This should help to negate any argument by him that the couple should stay married until year-end and file a joint return.

Alternatively, Wifester could be encouraged to consider releasing one (or both) of the personal exemption deductions for the children to Hubster for the year. This is done using Form 8332 and would result in a refund for Hubster and a reduced refund for Wifester.

Comment: When both spouses have fairly significant taxable incomes, tax savings will often result from divorcing before year-end. However, this cannot be taken for granted, as this example illustrates. The tax adviser should prepare an analysis of the tax results for the year with and without a divorce, taking into account how income and deduction items will be allocated between the individuals and the filing status options open to them.

Postponing Divorce to Collect "Marriage Dividend"

In many cases, it will turn out that staying married and filing a joint return results in a lower overall tax liability. This can occur when one party earns high income and one earns little or no income. In this circumstance, the joint filing rates greatly benefit the high-earning individual.

Example 6-4

Postponing Divorce Would Save on Taxes

Hubster and Wifester are contemplating whether they should attempt to finalize their divorce this year or early next year. Hubster will earn $95,000 from his employment this year and have $12,000 of FIT withheld. Wifester works part time and will earn $10,000 of income this year and have nothing withheld. The couple has 2 children. For simplicity, the standard deduction will be taken, and Hubster will be entitled to the dependent exemption deductions for the 2 children if separate returns are filed for the year.

Hubster and Wifester live in a state where pre-divorce taxable earnings and related tax withholdings are allocated to the spouse earning the income. Neither individual will qualify for HOH filing status. (These are the same facts as in example 61.) Accordingly, a divorce before year-end would result in both parties filing as single taxpayers. The results of joint and single filings are shown as follows (2011 rates):

	Joint Return	Single Returns	
		Hubster	Wifester
Income	$105,000	$95,000	$10,000
Standard deduction	(11,600)	(5,800)	(5,800)
Personal exemptions	(14,800)	(11,100)	(3,700)
Taxable income	$78,600	$78,100	$500
Tax liability	$11,900	$15,650	$50
Amount owed (refund)	($100)	$3,650	$50

In this example, you can clearly see why Hubster may strongly prefer remaining married through year-end and filing a joint return. (However, the tax results of remaining married and filing MFS returns would be even worse for Hubster than shown here. See example 6-1.)

Because of the tax liability exposure issue explained in this example, Wifester should agree to a joint return only if she is confident the return will properly reflect all income and deduction items and that the tax liability shown on the return has been or will be paid by Hubster. (Wifester may be wise to insist on engaging a professional to prepare the return.)

Comment: The tax adviser should prepare an analysis of the tax results for the year with and without a divorce, taking into account how income and deduction items will be allocated between the individuals and the filing status options open to them. For this fact pattern, such an analysis has been done in example 6-1 and in this example.

Avoiding Pre-Divorce Tax Fiascos With IRA and Qualified Retirement Plan Assets

Clients contemplating divorce are generally aware that their IRA and qualified retirement plan (QRP) assets will likely be divided up as part of the divorce. IRAs and QRP accounts *can* be split in a tax-effective manner if this is done as part of the divorce decree or property settlement agreement.

Sometimes when the client is getting along well with the soon-to-be-ex-spouse, the client may be tempted to transact a *pre-divorce* split of IRAs and QRP accounts. This is especially likely in a community property state when the client clearly understands the spouse will wind up with half of the account balances anyway, when all is said and done.

The client may think that, before the divorce, funds can simply be withdrawn from the client's accounts and transferred tax-free into the spouse's IRA or QRP account. The client may also think that such pre-divorce *do-it-yourself* transactions will save legal and accounting fees. Although these ideas seem to make sense, nothing could be further from the truth. The danger level intensifies when the client functions as the trustee of his or her QRP and therefore has the power to unilaterally take action without the benefit of professional advice.

The truth is, amounts withdrawn by the client before the divorce will generally be treated as fully *taxable* distributions to the client. They will *not* be taxed to the other spouse who actually receives the funds; nor will they qualify for a tax-free rollover into the spouse's IRA or QRP account. Instead, the client's spouse will own the funds tax-free, because the tax is imposed on the client.

If the client is under age 59½ at the time of the withdrawal, the 10 percent premature withdrawal penalty tax will generally apply *on top* of the regular income tax liability.[31] Finally, amounts cannot be withdrawn from QRP accounts except for reasons specified in plan documents. Satisfying the client's desire to accomplish a pre-divorce split of marital assets is not one of those reasons, and a withdrawal could have the effect of disqualifying the client's retirement plan.

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[31] IRC sec. 72(t).

The message in this section is simple: Proper planning is critical to achieve acceptable tax results when dividing up IRA and QRP assets in a divorce case. In this area, irreparable damage can result when tax advisers do not find out about transactions until after they have occurred. See the following discussion for planning steps and horror stories when these steps are not followed.

Planning to Achieve Tax-Effective Splits of IRA and QRP Assets

When clients divorce, IRA and QRP assets will often be divided up as part of the property settlement. The expectation of the parties is generally that the individual receiving the retirement account funds will be the one who pays the related income taxes. However, predivorce planning is necessary to achieve this *common-sense* tax outcome.

Splitting Up IRA Assets

Pursuant to a *divorce or separation instrument*, an individual can make a tax-free transfer of his or her interest in an IRA to the spouse or former spouse. The other party then treats the IRA as his or her own and follows the usual rules regarding taxability of subsequent distributions. In other words, the other party can then withdraw the IRA funds as he or she chooses and pay the resulting taxes. The preceding treatment is under a special rule provided by IRC Section 408(d)(6).

Note that the exact same rule applies to simplified employee pension (SEP) accounts, because they are considered IRAs for this purpose.

For purposes of this rule, a divorce or separation instrument is defined as a divorce decree, a decree of separate maintenance, or a written instrument incident to such a decree (such as a divorce property settlement agreement).

Any other action that has the effect of transferring IRA funds to a spouse or ex-spouse—*before or after* a divorce—will cause the account owner to owe the income taxes, even though the other party winds up with the funds. Such transactions are simply treated as fully taxable distributions to the account owner, who is then deemed to turn the funds over to the other party.[32] If the account owner is under age 59½ at the time such a transfer is made, the 10 percent penalty tax on premature withdrawals will generally apply *on top* of the "regular" income tax liability.[33] The funds received by the spouse or ex-spouse will *not* be eligible for tax-free rollover into an IRA set up for that person.

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[32] See Ltr. Rul. 9422060; *Richard C. Czepiel*, TC Memo 1999-289; the same thing would have happened in Ltr. Rul. 199937055 if the couple had gone through with the transaction. See also Michael G. Bunney, 114 TC No. 17 (Tax Court, 2000). In the latter case, the fact that the wife held a community property interest in husband's individual retirement account (IRA) did not change the tax results. The husband still owed the federal income tax, plus the 10 percent premature withdrawal penalty, when he withdrew cash from his IRA and gave it to his ex-wife as called for by the divorce settlement.

[33] IRC sec. 72(t).

One clearly permissible method for effecting an IRC Section 408(d)(6) tax-free transfer of IRA funds is to make a *trustee to trustee* transfer directly from the account owner's IRA to a new IRA set up for the spouse or ex-spouse. (Such transfers do not actually pass through the hands of either the account owner or the other party.) It is *less* clear that a distribution check made payable to the other party followed by a rollover within 60 days into that person's IRA would also qualify.

> **Note:** The same considerations apply to SEP accounts, because SEP accounts are treated as IRAs for purposes of the tax rules applicable to distributions.

Example 6-5

Misguided Attempt to Split IRA Funds Before Divorce

In Private Letter Ruling (PLR) 9422060, the IRS decided the tax impact of a husband's pre-divorce transfer of funds from his IRA into an IRA held by his wife.

Because the transfer was *not* an IRC Section 408(d)(6) transfer pursuant to a divorce or separation instrument, the transaction was treated as a fully taxable constructive distribution to the husband. Thus, he got the income tax bill, while his wife got the money. This was certainly not what the couple expected (especially the husband); however, the wife presumably had no complaints after finding out she had received a tax-free windfall. (Actually, the wife's IRA trustee should not have permitted the transfer of funds into her IRA because the money did not qualify as a distribution eligible for rollover treatment.)

Note: PLR 8820086 reaches the same conclusion regarding attempted pre-divorce transfers from one spouse's IRA to an IRA held by the other. Finally, the U.S. Tax Court confirms that the same tax outcome applies when an individual attempts to make a postdivorce transfer of funds from an IRA to an ex-spouse to satisfy financial terms of the divorce decree.[34]

Strategy 6-5

Tell your clients that they should *not* make pre-divorce or postdivorce transfers of IRA funds except as specifically required under the terms of a divorce document.

To ensure a tax-free transfer, the divorce document should specify that the transfer of IRA funds is intended to be tax-free under IRC Section 408(d)(6). The author also recommends that the transfer be made via a *trustee to trustee* transfer of funds directly from the account owner's IRA to a new IRA set up for the spouse or ex-spouse. (See practice aid 6-4 for a sample letter to divorce attorney contacts on this issue.)

Splitting Up QRP Account Assets

A more complicated maneuver is required to effect a tax-free transfer to a spouse or ex-spouse of assets held in QRP accounts. For this purpose, QRP accounts include those under an employer's pension, profit-sharing, or IRC Section 401(k) plan; a self-employed Keogh plan; or an IRC Section 403(b) tax-sheltered annuity plan.

The *general* rule is that transfers of assets in QRP accounts to anyone other than the plan participant (the individual for whom the account is set up) are *not* permitted.[35] Transfers

[34] *Paul D. Harris*, TC Memo 1991-375.

[35] IRC sec. 401(a)(13)(A).

to other parties, including the participant's spouse or ex-spouse, are treated as fully taxable constructive distributions to the participant, who is then deemed to transfer the funds to the other party. In other words, the participant's spouse or ex-spouse could end up with the QRP funds, while the participant simply ends up with the income tax bill.

Beyond this extremely adverse tax outcome, such distributions may also cause disqualification of the retirement plan, because plan terms allow distributions to participants only under specified circumstances (such as reaching retirement age, separation from service, and so on).

Qualified Domestic Relations Orders to the Rescue

Fortunately, the preceding bad news can be avoided by transferring QRP account assets to a spouse or ex-spouse via a qualified domestic relations order (QDRO).

A *QDRO* is a legal judgment, decree, or order (including one approving a divorce property settlement agreement) that meets certain IRC guidelines. It can be a separate document or simply language included as part of another divorce-related document, such as the property settlement. The QDRO establishes that one spouse or ex-spouse has the legal right to receive all or part of the other party's QRP benefits without violating the plan's benefit distribution rules.

The QDRO also has the important and desirable side-effect of ensuring that the spouse or ex-spouse receiving the benefits—and not the participant—owes the related income taxes. In other words, the person who gets the money owes the taxes, which is exactly what the parties should expect to happen.

What Is Needed to Establish a QDRO?

For a QDRO to exist, there must be language in a divorce document that meets *all* of the following requirements, as set forth in IRC Section 414(p):

- It must provide for child support, alimony payments, or marital property rights for a spouse, former spouse, child, or other dependent of a qualified plan participant, *and* it must be made pursuant to a state domestic relations law (including a community property law).
- It must create or recognize the existence of the right of the individual named previously—who is termed the *alternate payee*—to receive all or a portion of a participant's benefits under a QRP.
- It must specify all of the following:
  - Name and last known mailing address of the participant and each alternate payee covered by the order (In divorce situations, there is usually only one alternate payee—the ex-spouse.)
  - Amount or percentage of the participant's benefits to be paid by the plan to each alternate payee or the manner in which the amount or percentage is to be determined (when possible, the simplest way to conform with this rule is to arrange for a lump-sum payment of a set amount to the alternate payee)

— Number of payments or periods to which the order relates (again, the simplest way to comply with this requirement is by calling for a lump-sum payment when possible)
— Each QRP to which the order applies (The simplest procedure is to call for the alternate payee to receive payment[s] from only one plan when there are several.)

- To constitute a QDRO, an order must not
  — require the plan to pay increased benefits beyond what the participant is normally entitled to,
  — require the plan to pay benefits to an alternate payee when those benefits must be paid to a different alternate payee pursuant to another QDRO (such as one arising from an earlier divorce), or
  — require the plan to provide a type or form of benefit (such as a lump sum) or any option that is not otherwise provided for by the terms of the plan.

Key Point: Although the previous requirements are generally *not* difficult to meet, failure can be disastrous, as illustrated by the real-life story in example 6-6. If a QRP distribution is made pursuant to divorce document language *not* meeting the definition of a QDRO, the plan participant can end up being taxed on funds received by the other party; this is truly a "one person gets the mine while the other gets the shaft" scenario. A tax professional does not want to be the one advising an individual on the wrong end of such a transaction.

Example 6-6

Tax Results Without Proper QDRO Language

The tax effects of attempting to split up QRP benefits without using a QDRO are best illustrated using a real-life example. Arthur Hawkins was an orthodontist in New Mexico who functioned as the plan administrator and sole trustee of his own retirement plan. Under a 1987 divorce decree, Arthur's former wife, Glenda, was awarded a property settlement of $1 million to be paid from Arthur's QRP account. Unfortunately, the divorce decree language did not specifically identify Glenda as an alternate payee, nor did it include her last known address.

The Tax Court concluded that Glenda's $1 million plan payout should be treated as a taxable distribution to *Arthur,* because the IRC Section 414(p) QDRO requirements were not explicitly met in writing. (If this happened today, Arthur would probably owe $350,000 in federal income tax plus the 10 percent penalty tax on premature withdrawals if the distribution occurred before he was age 59½.)

Arthur appealed to the Tenth Circuit and finally won at that level.

The appeals court decided Glenda's legal right to QRP benefits was defined in the divorce decree. Thus she *was* an alternate payee even though not described as such in the document. The amount she was entitled to was clearly $1 million, and the payment terms were clear. The court waived the requirement that Glenda's last known address be included in the divorce decree, because Arthur was the plan administrator and Glenda admitted he knew her address.

Based on the circumstances, the court concluded the language in the divorce decree could be construed as constituting a QDRO. Therefore Glenda, rather than Arthur, owed the taxes on the $1 million.[36]

Key Point: Although the taxpayer ultimately dodged the bullet in this case, the litigation costs were undoubtedly heavy. The entire mess could have been easily avoided by simply including proper QDRO language in the divorce decree.

Another horror story is provided by a Florida bankruptcy court decision. In this case, the taxpayer received a distribution from his QRP account and used the money to pay an amount owed to his ex-wife pursuant to the divorce decree. The language in the decree did not meet the IRC Section 414(p) QDRO requirements. Therefore, the participant, rather than the ex-wife, was taxed on the distribution even though she got the money.[37] In another case, a California taxpayer deposited his QRP distribution in his estranged wife's IRA before their subsequent divorce. The husband was taxed on the distribution.[38]

Some key points to consider are:

- When retirement plans are professionally administered (as is the case with most large-employer plans), it is less likely that a distribution pursuant to a divorce decree will be made without a proper QDRO being in place.
- However, when the divorcing client is a small-business owner who also acts as the administrator for the retirement plan in question, the odds of misbegotten distributions rise astronomically.
- Such clients have the power to make distributions unilaterally and often do so without obtaining proper professional advice.

Tax Results with QDRO in Place

The tax outcome from using a QDRO is what the divorcing couple would commonly tend to expect. Generally, the alternate payee (ex-spouse) *steps into the tax shoes* of the plan participant. Thus, the alternate payee is taxed when funds are withdrawn from the QRP account.

However, the 10 percent premature withdrawal penalty tax that generally applies to QRP distributions received before age 59½ does *not* apply to any distribution made pursuant to a QDRO.[39] Thus, an ex-spouse need not have attained that age to avoid the 10 percent penalty tax.

Funds distributed to the alternate payee can also be rolled over tax-free into an IRA set up for that person.[40] The rollover must be done within 60 days of the alternate payee's receipt of the distribution. Such rollovers should be accomplished via trustee-to-trustee direct transfers from the participant's QRP account to the ex-spouse's IRA. This avoids the mandatory 20 percent federal income tax withholding that will otherwise be taken out of the QRP distribution.

[36] See *Hawkins, Arthur C.*, 96-1 USTC 50,316 (10th Cir. 1996).

[37] See *Michael D. Boudreau*, 95-1 USTC 50,115 (BC-Fla. 1995).

[38] See *Mario Rodoni v. Commissioner*, 105 TC 29 (1995).

[39] IRC sec. 72(t)(2)(C).

[40] IRC sec. 402(e)(1)(B).

A few cautionary items to consider:

- Attorneys specializing in domestic relations cases are usually aware of the benefits of QDROs, but they may not understand the need to comply with the specific IRC Section 414(p) requirements.
- As a tax adviser, you should *not* assume that a divorce document will meet these requirements without intervention on your part.
- Failure to review divorce documents before they are executed can lead to client tax fiascos, as described earlier in this section.
- If that happens, there will be plenty of blame to spread around among all professionals involved with the divorce. See practice aid 6-4 at the end of this chapter for a sample letter to divorce attorney contacts.

IRS-Provided Sample QDRO Language

In the Small Business Job Protection Act of 1996, Congress directed the IRS to provide sample language to help taxpayers and professional advisers meet the QDRO requirements. In Notice 97-11, the IRS complied. Employing the sample language should reduce the risk of the adverse tax results discussed earlier in this section.

Backdoor Planning Technique If QDRO Is Not Feasible

In some cases, it will not be possible to arrange for a QDRO and the resulting tax benefits to the QRP participant. This may be because the divorce attorney intends to install a QDRO but does not properly draft the divorce documents, or it may be because the need for a QDRO was simply not recognized until after the divorce decree was executed.

Assuming the participant's spouse or ex-spouse has not already received the QRP distribution, it may be possible to use an IRA rollover technique to achieve acceptable tax results. If the participant deposits the taxable portion of distributed QRP funds intended for the other party into the participant's *own* IRA within 60 days of the distribution, the transaction will qualify as a tax-free rollover.[41] So far, so good.

The participant can then transfer his or her interest in the IRA tax-free to the spouse or ex-spouse under the IRC Section 408(d)(6) rules for IRAs. These rules are explained at the beginning of this section.

Example 6-7

Salvaging "Blown QDRO" With an IRA Split

Hubster and Wifester sign their divorce decree on July 1. Included in the property settlement section of the decree is a statement that Wifester is entitled to 50 percent of Hubster's retirement plan assets. However, the QDRO requirements are not met by the terms of the decree. The assets in question are in Hubster's 401(k) plan at his work.

[41] IRC sec. 402(c)(1) and (4).

Shortly after the divorce, Hubster quits his job and receives 100 percent of his retirement benefits as a lump-sum distribution. He intends to simply give half the cash to Wifester to satisfy the terms of the divorce decree. If he does this, he will be taxed on the 50 percent received by Wifester.

However, if Hubster deposits the distribution into his own IRA within 60 days, he can avoid this outcome. He should have the divorce decree amended to clarify that Wifester will receive 50 percent of Hubster's interest in the IRA under the IRC Section 408(d)(6) rules explained earlier in this chapter. The amended decree should specify that the transfer of IRA funds is intended to be tax-free under IRC Section 408(d)(6).

Hubster should then arrange for a trustee-to-trustee transfer of 50 percent of the funds directly from his IRA to a new IRA set up for Wifester. She will then be taxed on subsequent withdrawals from her IRA.

Planning to Achieve Equitable After-Tax Property Divisions

Property splits between divorcing couples should be structured to be fair to both parties on an after-tax basis. IRC Section 1041(a) provides the general rule that property transfers between divorcing spouses are treated as tax-free gifts, with the transferee taking over the transferor's basis and holding period. As a result, when one party ends up holding appreciated assets (such as real estate, securities, zero basis receivables, deferred compensation benefits, and so on), that person will generally owe tax when the assets are sold or converted into cash.

Some key points to consider for achieving equitable after-tax property divisions are:

- An equitable property settlement will account for the reduced value of appreciated assets caused by the *built-in* tax liabilities that come along for the ride.
- After-tax values can be illustrated using a balance sheet approach.
- The couple should then decide on an equitable property division based on these after-tax amounts.

Tax-free treatment under IRC Section 1041(a) is mandatory rather than elective and applies to any property transfers that are deemed incident to a divorce. There is no gain or loss even if cash is paid by one party for property held by the other or if liabilities exceed basis. Tax-free treatment applies whether the property was originally jointly owned or separately owned. (However, IRC Section 1041[a] does not apply to transfers to nonresident aliens.)

A transfer is incident to a divorce if

- transfer occurs within one year after the date on which the marriage ceases (with the date this occurs to be determined under state law) *or*
- transfer is related to the cessation of the marriage. Any transfer pursuant to a divorce or separation instrument within six years after the date the marriage ceases is presumed to be related to the cessation of the marriage.

Transfers between former spouses that fall outside the previous time limits are treated as taxable sales or as gifts, depending on the circumstances. Transfers falling within these limits are presumed to be incident to the divorce and are therefore tax-free under IRC Section

1041. For instance, one ex-spouse can acquire property *after* the divorce and transfer it tax-free to the other ex-spouse as long as this occurs within one year of the date of divorce.[42]

Taking Advantage of the Tax-Free Transfer Rule

The ability to transfer property tax-free, within the previously mentioned limits, can help the parties deal with cash flow problems, as the following examples illustrate.

Example 6-8

Post-Divorce Transfer of Property for Cash

Bill and Karen are divorced on July 1. Shortly thereafter, Karen realizes that she is facing a major cash crunch. Bill is willing to help her solve the problem by giving Karen $36,000 cash in exchange for her rare stamp collection, which is worth $50,000 and has a tax basis of $200.

The deal is done on August 15. Because this is within one year of the divorce date, the transaction is tax-free under IRC Section 1041(a). Bill takes over Karen's $200 tax basis in the collection. He will eventually owe tax on the difference between fair market value (FMV) and $200, which is why he was willing to pay only $36,000. (If Bill does not understand the carryover basis rule, he may unwittingly pay the full FMV of $50,000, which would be a windfall for Karen.)

Note: If Bill bought the card collection more than one year after the divorce, it would be treated as a taxable purchase or sale transaction, unless it was called for in the divorce decree and occurred within six years of the divorce date. If taxable purchase or sale treatment applies, Karen should insist on receiving the full $50,000 FMV, because Bill would obtain a stepped-up tax basis in the collection and she would owe tax on the gain.

When the divorcing individuals face significantly different marginal tax rates after the split, it can be beneficial to take advantage of the IRC Section 1041(a) tax-free transfer rule by transferring appreciated property from the higher-income spouse to the lower-income spouse in order to save on taxes when the property is sold.

Example 6-9

Post-Divorce Transfer Saves on Taxes

Chuck (a starving artist) and Donna (a successful attorney) will become divorced on February 1. Prior to finalizing the decree, the couple has tentatively agreed that Donna will be obligated to pay Chuck $100,000 as soon as possible after the divorce as part of the property settlement. However Donna's marginal tax rate (federal and state combined) is 45 percent, and her only significant liquid asset is short-term capital gain property worth $100,000 with tax basis of $20,000. Chuck's marginal tax rate is only 18 percent.

If Donna sells the property and pays the taxes, she will net only $64,000 and will still be $36,000 short of what she needs to pay Chuck. However, if she transfers the property to Chuck and he sells it, he will net $85,600. Chuck will agree to this if Donna agrees to pay him an additional $20,000 to cover his taxes and the aggravation. Donna agrees as long as the $20,000 can be structured as a deductible alimony payment to Chuck.

[42] See sec. 1041(c) and Temp. Reg. 1.1041-1T(b), Q&As 6 and 7.

Under this arrangement Donna is out of pocket for an additional $20,000, with the amount treated as deductible alimony. Because the alimony is deductible, her after-tax cost is only $11,000 (55 percent of $20,000). From her perspective this is much better than the $36,000 shortfall she would otherwise face. Chuck will collect a total of $120,000 and owe taxes of $18,000 (18 percent × [$80,000 + 20,000]). The transfer of appreciated property allows both parties to come out ahead on an after-tax basis.

Transfers of Ordinary-Income Assets

For years, the IRS appeared to state that the IRC Section 1041 tax-free transfer rule only applied to capital-gain assets.[43] For instance, if a taxpayer transferred business receivables, inventory, or vested nonqualified stock options to his or her spouse in divorce, the IRS wanted the taxpayer to report the date-of-transfer difference between fair market value and basis as ordinary income on his or her Form 1040 (U.S. Individual Income Tax Return). In other words, the taxpayer paid the tax, even though his or her ex got the cheese.

Now, it appears the IRS has reversed its field and concluded that most ordinary income assets *can* be transferred tax-free under the IRC Section 1041(a) rule. If so, the spouse who winds up with the asset must recognize the income when the asset is sold, converted to cash, or exercised in the case of stock options. Fair enough.

Key Point: In support of the preceding conclusion, see Revenue Ruling 2002-22 which deals specifically with vested nonqualified employer stock options and nonqualified deferred compensation rights but which appears to have wider applicability.

Planning for Children's Dependent Exemption Deductions

The issue of who gets to claim the children's dependent exemption deductions often becomes thorny in divorce cases. When the parents are divorced or legally separated at year-end, the parent with whom the child spends the greater part of the year (the *custodial parent*) is *automatically* entitled to the exemption ($3,800 for 2012) regardless of who provides the support.[44] Despite this general rule, the custodial parent can *agree* to release the exemption deduction to the noncustodial parent. The release can be for a single year, a specified number of years, or forever.

The procedure for the noncustodial parent to obtain the release is via Form 8332. The custodial parent must sign Form 8332, and a copy is then filed with the noncustodial parent's tax return for each year the release applies. A separate form is required for each child.

Note: The $1,000 per dependent child credit under IRC Section 24 is only available to the parent who can claim the dependency exemption for the qualifying

[43] See, for example, Rev. Rul. 87-12, PLR 8813023, and Field Service Advice 200005006.

[44] IRC sec. 152(e).

child.[45] Ditto for the American Opportunity and Lifetime Learning tax credits for the child's higher education expenses.[46] The same is true for the deduction for qualified education loan interest and the deduction for college tuition and related costs. Eligibility for these tax breaks is another reason why obtaining a signed Form 8332 is important.

Strategy 6-6

For the reasons discussed in this section, it is always best to obtain a signed Form 8332. Experience shows that the odds are slim of obtaining a signature *after* the other divorce paperwork has been signed off. (There is usually residual hostility that manifests itself as an uncooperative attitude.) Therefore, the signed Form 8332 should be obtained at the same time the parties meet to sign the other divorce-related documents.

Planning to Qualify Payments as Deductible Alimony

One of the most commonly encountered client situations is the ex-spouse who expects the payments made to the other to be deductible as alimony. However, a number of requirements must be met for alimony treatment to apply. Unfortunately, attorneys often draft divorce papers in such a way that alimony treatment is *not* available.

When payments fail to meet the federal income tax definition of alimony, they are generally treated as either child support payments or as payments to divide the marital property (that is, part of the divorce property settlement). In either case, the payments are nondeductible personal expenses for the payer and tax-free income to the payee.

On the other hand, payments that meet the IRC definition of alimony are treated as such for federal income tax purposes, regardless of how the payments are described in the divorce agreement or under state law.[47]

This section deals with planning tips to ensure that payments intended to be alimony are actually respected as such for federal income tax purposes.

Requirements for Payments to Constitute Alimony

Payments that qualify as alimony represent above-the-line deductions for the payer and taxable income to the payee.[48] As mentioned, whether or not payments qualify is determined strictly by the IRC and not by the divorce decree, court order, or intentions of the divorcing couple. This essential fact is misunderstood by many otherwise competent divorce attorneys.

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45 IRC sec. 24(c)(1).

46 See IRC sec. 25A(f)(1)(A)(iii) and (g)(3).

47 For example, see *Thomas H. Nelson, et ux. v. Commissioner,* TC Memo 1998-268.

48 IRC secs. 71(a) and 215(a).

In other words, a payment may be referred to as *alimony* in the divorce papers and be intended by the parties to be alimony but still fail to qualify as such under the IRC. Nonqualifying payments will be considered nondeductible child support or divisions of marital property for federal income tax purposes. On the other hand, it is also possible (although relatively unlikely) for payments not referred to as, or intended to be, alimony to meet the IRC definition. In such case, they will be deductible by the payer and taxable income to the payee.

In order for a payment to be treated as alimony for federal income tax purposes, *all* of the following requirements (explained in more detail later in this section) must be met:

- It must be made under a written divorce or separation instrument and the instrument cannot state the payment is *not* alimony. (Qualifying payments can occur both before and after the couple is divorced or legally separated.)
- After divorce or legal separation (that is, the couple is considered divorced for federal income tax purposes), the ex-spouses cannot live in the same household or file a joint return.
- The payment must be made to a spouse or ex-spouse and be in cash or a cash equivalent.
- The payment must not be fixed or deemed child support. (Child support payments are nondeductible to the payer and tax-free to the payee.)
- The obligation to make payments, other than payment of delinquent amounts, must cease when the payee dies.

The last two requirements in the previous list cause the most trouble.

- If payment obligations continue after the payee ex-spouse dies, the payments are not alimony. For example, an ex-husband's monthly payments intended to cover his ex-wife's mortgage payments will not qualify as alimony if the husband's payments are required to continue after the ex-wife's death. Such payments would be a nondeductible expense for the ex-husband and tax-free money to the ex-wife.[49]
- On the other hand, the payer ex-spouse's estate can be required to continue to make payments after the payer dies without running afoul of the federal income tax definition of alimony.

Payment obligations deemed to be child support payments are discussed later in this section.

Divorce instruments will often call for one or both parties to make a variety of payments to each other. Each payment or stream of payments is tested independently to determine if it qualifies as alimony. The fact that one payment or stream fails does not affect the ability of other payments or streams of payments to meet the definition.

[49] See *Elizabeth S. Pettet* v. U.S., E.D.N.C., November 10, 1997.

Example 6-10

Testing Different Payment Streams

Bob and Carol are scheduled to become divorced on July 1. Pursuant to the current discussion draft version of the divorce decree, Bob will be required to make the following post-divorce payments to Carol:

- $1,500 per month is designated as child support until such time as the couple's child is age 21 or no longer living.
- $1,000 per month for 10 years is designated in the decree as alimony.
- 50 percent of the shares in Bob's restricted stock bonus account with his employer, as of July 1 (also stated to be alimony in the decree)must be delivered to Carol within 30 days of the date Bob becomes fully vested which will be in 5 years, assuming he continues to work for his existing employer.

If Bob dies, his estate is obligated to make the payments listed previously.

Under the rules listed earlier in this section, none of these payments will qualify as alimony. The monthly amounts stated to be child support are disqualified for that reason. The monthly amounts stated to be alimony are disqualified because they do not cease upon Carol's death. The payment of restricted stock fails to qualify because it is not in cash and because it must be paid even if Carol dies.

If the divorce decree is changed to specify that the $1,000-per-month payments would cease upon Carol's death, they would qualify. If the decree is changed to require Bob to pay cash equal to the value of the restricted stock when Bob becomes vested, that amount would also qualify, as long as Bob is not required to make payments after Carol's death.

Example 6-11

Payment Streams That Cease Upon Payee's Death

Mick and Annie are to be divorced on July 15. Under the terms of the decree, Mick will be obligated to make payments to Annie of $2,000 per month, starting on August 1, for 10 years or until she dies, whichever comes first. If Mick dies, his estate must continue to meet his obligation to Annie. If Annie dies, Mick must continue to pay $900 per month until Jarvis, their child, reaches age 18 (these post-death payments would be to a trust set up for the child's benefit).

In this example, there are actually two payment streams: one that ceases upon Annie's death, and one that continues. The one that continues ($900 per month) does not qualify as alimony. Therefore, Mick can deduct only $1,100 per month as alimony, under these facts.

If the decree states that Mick owes a lump sum upon Annie's death equal to the difference between $240,000 (10 years' worth of payments) and the payments already made, none of the payments will qualify as alimony because the decree includes an *acceleration clause* which effectively causes the full amount to be paid, whether or not Annie actually lives for 10 years.[50]

Written Instrument Rule

A written divorce or separation instrument includes a divorce decree, a separate maintenance decree, or a separation instrument.[51] The difference between these documents is that a divorce decree is issued when the marriage is dissolved. A separate maintenance decree means the couple is legally separated and living apart, but the marriage is not yet legally dissolved.

[50] Temp. Reg. 1.71-1T(b).

[51] Temp. Reg. 1.71(b)(2).

However, the couple is considered legally separated and thus no longer married for federal income tax purposes.

A separation instrument settles the terms of the couple's marital rights and can be issued in advance of a divorce or separate maintenance decree. Other written court orders and decrees such as temporary support orders (which cover the time after a divorce or separate maintenance petition is filed but *before* the divorce or legal separation is granted) also qualify as divorce or separation instruments. So-called *temporary alimony* payments under temporary support orders can qualify as alimony as long as the other requirements listed earlier are met.[52]

Pre-divorce payments under both separation agreements and temporary support orders can qualify even while the couple continues to live in the same household. After a divorce or separate maintenance decree is granted, the couple must live apart in order for payments to qualify.

Some key points to consider for written instrument rules are:

- Payments made prior to executing a written divorce or separation instrument or prior to the effective date of a court order or decree cannot be considered alimony.
  - Such payments are considered voluntary because they are made before there is any legal requirement to do so.
- The same is true for any payments in excess of what is required under a written divorce or separation instrument or court order or decree. Clients should be advised of this before they make voluntary payments.

Cash or Cash Equivalent Rule

Checks and money orders count as cash equivalents. Marketable securities, bonds, promissory notes, and so on do not, nor do transfers of services or property rights, such as free rent for use of the payer's residence or free maintenance work done by the payer.[53]

Payment to Third Parties

Alimony can be paid directly to or indirectly on *behalf* of the payee spouse or ex-spouse. However, for indirect payments to qualify, they must be made under the terms of the divorce or separation instrument or at the written request of (or with the written consent of) the payee. Any written request or consent must state the payments are intended to be alimony and the payer spouse must have the document before the tax return is filed for the year the payments were made.[54]

For instance, the payer may be required to make the payee's mortgage payments under terms of the divorce decree, or the payee may request that his or her rent or medical bills be paid in lieu of part of that month's alimony payment.

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[52] Temp. Reg. 1.71-1(b).

[53] Temp. Reg. 1.71-1T(b), Q&A 5.

[54] Temp. Reg. 1.71-1T(b), Q&As 6 and 7.

However, the payer cannot deduct payments to maintain property still owned by the payer. For example, an individual cannot deduct as alimony mortgage payments on a house he or she owns but that is used by the spouse or ex-spouse.

Ceases on Death of Payee Rule

Payment obligations that do *not* cease upon the death of the payee cannot be considered alimony. Regardless of what they may be called in the divorce papers, such payments are considered either child support or divisions of marital property for federal income tax purposes.

Each payment stream is tested separately to determine if it ceases upon death of the payee. Amounts that continue are disqualified, but this does not affect the ability of other payments to qualify. Payments may be required to continue after the death of the payer as obligations of his or her estate. Such a requirement does not disqualify the payments as alimony. Only payments that continue after the death of the *payee* are disqualified.

If the divorce papers do not indicate whether or not payments must continue in the event of the payee's death, state law controls. In other words, if under state law the payer must continue to make the payments, they are not alimony. If under state law the payments cease, they qualify as alimony as long as the other requirements listed earlier in this section are satisfied.

Strategy 6-7

To avoid problems, the divorce papers should explicitly state whether each lump-sum and periodic payment obligation continues after the death of the payee. Failure to deal with this issue in divorce instruments is perhaps the most common reason for the unexpected loss of alimony deductions and resulting client dissatisfaction. Practitioners should *not* assume that state law will answer the question, because it can be unclear in many cases.

Alimony Received Is Earned Income for IRA Contribution Purposes

Contributions to traditional or Roth IRAs cannot exceed the contributor's earned income amount for the year. For purposes of this rule, alimony received is considered earned income.[55] Thus, an individual whose only other sources of income are "unearned" (for example, from investments or trust fund distributions) is still able to make IRA contributions based on the earned income from alimony payments received. Remember, however, that contributions to traditional IRAs cannot be made for years when the individual is age 70½ or older as of year-end.[56]

[55] IRC sec. 219(f)(1).

[56] IRC sec. 219(d)(1).

Avoiding Characterization of Payments as Child Support

The seemingly simple rule that alimony does not include amounts considered to be child support causes many problems in real life. Payments are for child support if they are

- fixed child support or
- deemed child support.

Fixed Child Support

Fixed child support means amounts designated as such in the divorce or separation instrument (for example, when the document explicitly requires a parent to pay $1,000 per month for child support until the children reach certain ages).

Deemed Child Support

Deemed child support is a much trickier concept and creates a trap for unwary taxpayers. *Deemed child support* payments are amounts that are not identified as such in the divorce or separation agreement, but that are considered to be child support under the federal income tax rules. Specifically, amounts are considered deemed child support to the extent of payment *reductions* triggered by certain contingencies relating to a child (such as the child reaching age 18). This is the case even if the divorce or separation instrument unambiguously states the full payment is to be considered alimony for federal income tax purposes.[57] Contingencies relating to a child include the following:

- Attaining age 18, 21, or the local age of majority (adulthood)
- Death
- Marriage
- Completion of schooling
- Leaving the household
- Attaining a specified income level
- Employment

"Clearly Associated" Rules

In addition to the previously discussed *triggering events*, payment reductions that occur *within 6 months* before or after a child reaches age 18, 21, or the local age of majority are considered *clearly associated* with, and thus triggered by, a contingency related to a child.

Also, when there are 2 or more children and payments are to be reduced on 2 or more occasions, and any of the reductions occurs *within 1 year* before or after the date each child reaches any age between 18 and 24 inclusive, with the same age being used for each child, the reductions are considered *clearly associated* with a contingency related to a child.

[57] Temp. Reg. 1.71-1T(c).

Strategy 6-8

Although payment reductions that fall under either of the first or second *clearly associated* rules are presumed to be child support, the presumption can be rebutted by showing the reductions are actually due to reasons unrelated to child contingencies. For example, if, under local law, the term for alimony payments is limited to half the number of years of marriage, a payment reduction based on that rule would not be considered child support even if it fell within 6 months of a child's 18th birthday. Another example would be when payments are reduced or cease near the date when the ex-spouse becomes entitled to distributions or increased distributions from a trust set up for his or her benefit by his or her parents.[58]

When the presumption can be rebutted, the reason for the payment reduction (for example, the ex-spouse becoming eligible for trust distributions) should be identified in the divorce documents to avoid later IRS disputes.

Example 6-12

Fixed Child Support

Buck and Jewel are divorced on July 1. Under terms of the decree, Buck must pay Jewel $4,000 per month for 120 months (10 years), starting on July 15. The requirement to make payments ceases if Jewel dies. The payments meet all of the other requirements for alimony explained earlier in this section, except that the document states that $1,800 per month is for the support of the couple's two children (ages 3 and 5) who will live with Jewel.

Any amount designated as child support is not alimony (even though the child support payments would stop if Jewel dies). Thus, Buck can deduct as alimony only $2,200 per month.

Example 6-13

Deemed Child Support Under Child Contingency Rule

Buck and Jewel are divorced on July 1, 2009. Under terms of the decree, Buck must pay Jewel $4,000 per month for 120 months, starting on July 15, 2009, and ending on June 15, 2019. The requirement to make payments ceases if Jewel dies.

In addition, payments due after January 6, 2013, are reduced to $3,100 per month, and payments due after May 21, 2016, are reduced to $2,200 per month. Those 2 dates represent the 18th birthdays of the couple's 2 children (for purposes of this example, 21 is the age of majority under local law). The payments meet all of the other requirements for alimony explained earlier in this section.

Because there are $1,800 worth of payment reductions triggered by contingencies related to the children (their 18th birthdays), $1,800 of each monthly payment is considered child support and *not* alimony. Thus, Buck can deduct as alimony only $2,200 per month.

Consider the following key points:

- Planners should be especially careful to avoid situations in which the date that payments cease falls on the 18th or 21st birthday of a child.
- In this example, if the payments end on May 21, 2019, all amounts would be treated as child support.
- The 2 $900 reductions would be child support because they occur on the children's 18th birthdays, and the final $2,200 reduction would be considered child support because it occurs on the second child's 21st birthday.
- As explained in example 6-14, the same results would also apply (under the first clearly associated rule) if the payment reductions occur within 6 months of the children's 18th or 21st birthdays.

[58] See Temp. Reg. 1.71-1T(c), Q&A 18.

Example 6-14

Deemed Child Support Under First "Clearly Associated" Rule

Use the same facts as in example 6-13, except that now the payment reductions do not occur exactly on the 18th birthdays of the children.

Buck has not necessarily dodged the problem. Under the *first clearly associated rule*, the same results as in example 6-13 will also apply if the payment reductions will occur within 6 months before or after their 18th birthdays, their 21st birthdays, or upon reaching the age of majority under local law.

Planners should be especially careful to avoid situations in which the date payments cease falls within 6 months of the 18th or 21st birthdays of a child.

In this example, if the payments are reduced to $3,100 and $2,200 on June 15, 2013, and June 15, 2016, and cease on June 15, 2019, all amounts would be treated as child support. The 2 $900 reductions would be child support because they both occur within 6 months of the children's 18th birthdays, and the final $2,200 reduction would be considered child support because it occurs within 6 months of the younger child's 21st birthday.

Strategy 6-9

If Buck and Jewel had only 1 child, the *clearly associated* rule could be avoided simply by making sure that any payment reductions do not fall within 6 months before or after the attainment of ages 18 or 21. For example, payment reductions could be scheduled to occur on the child's 19th, 20th, or 22nd birthdays (or on all those dates), which would make 100 percent of Buck's monthly payments qualify as alimony.

Avoiding Alimony Recapture

Congress realized that taxpayers would attempt to disguise what were actually divisions of marital property as deductible alimony payments. Accordingly, the IRC Section 71(f) alimony recapture rules were enacted to prevent this.

IRC Section 71(f) imposes a mechanical test to measure whether purported alimony payments are excessively "front-loaded" during the first three calendar years that alimony payments *are* made. When payments are excessively front-loaded, the presumption is that part of the payments are actually in the nature of a property settlement. Therefore, part of the alimony deductions taken in the first *two* years is recaptured. The payer must take the recaptured amount back into gross income in the third year, and the payee gets an alimony deduction for the same amount in that year.

Failure to recognize and *plan around* the recapture rules can result in unexpected loss of alimony deductions and the inevitable client dissatisfaction.

Affected Payments

The alimony recapture rules do *not* affect payments occurring after the first 2 years, and they do not apply at all when payments in the first 2 years are $15,000 or less. Recapture does not apply to the second-year amount when it exceeds the third-year amount by $15,000 or less, nor does it apply to the first-year amount when it exceeds the average of the second- and third-year amounts by $15,000 or less. For example, a payment stream of $22,500 in the first year, $15,000 in the second year, and $0 in the third year does not result in any recapture.

See the worksheet in IRS Publication 504, *Divorced or Separated Individuals*, to calculate alimony recapture amounts, if any.

Exceptions to Recapture Rules

The recapture calculation is based on a three-year period starting with the first year alimony payments that are made under a divorce decree, separate maintenance decree, or separation agreement. Thus, alimony recapture does not apply to payments made pursuant to other decrees or court orders such as temporary support orders because such payments are *before* the commencement of the three-year period.[59]

Alimony recapture also does not apply when the reason for the excessive front-loading is the death of either spouse within the three-year period or the remarriage of the payee spouse within the three-year period.[60]

Finally, alimony recapture does not apply to payment obligations that over the three-year period are based on a fixed portion of the payer's income from a business, property, or compensation from employment or self-employment.[61] This is because payments based on these items can fluctuate for reasons beyond the payer's control.

> **Key Point:** There are no exceptions for payment fluctuations caused by other factors such as illness, loss of job, cash-flow problems, or amendments to the divorce decree. In other words, the recapture calculations are based on actual payments rather than scheduled amounts.

[59] IRC sec. 71(f)(5)(B).

[60] IRC sec. 71(f)(5)(A).

[61] IRC sec. 71(f)(5)(C).

Practice Aid 6-1: Divorce Tax Planning Checklist

Explanation: Use this checklist to avoiding missing critical tax issues and planning opportunities.

Pre-Divorce Tax Filing and Planning Considerations		
______	1.	For open pre-divorce years, has client considered advantages of filing separate return? (Client should clearly understand negative factors associated with joint filing status.)
______	2.	Can client qualify for head of household status if he or she files separately?
______	3.	If client lives in community property state, is the favorable Internal Revenue Code (IRC) Section 66 rule available if separate returns will be filed? (This rule can prevent disadvantageous allocations of taxable income for the lower-earning spouse.)
______	4.	If separate returns are filed, consider who will receive the children's dependent exemption deductions.
______	5.	Consider the other options to avoid exposure to tax liabilities caused by other spouse's actions, including potential relief under the innocent spouse rules.
______	6.	Consider whether the optimal time for finalizing the divorce is the current year or next year.
Avoiding Problems With Individual Retirement Accounts and Qualified Retirement Plan Assets		
______	1.	Make sure client is counseled to avoid pre-divorce transfers of funds from one spouse's individual retirement account (IRA) to the other's IRA (these will trigger immediate tax liabilities).
______	2.	Make sure qualified retirement plan assets are split via qualified domestic relations orders to avoid situations in which one spouse receives the funds while the other owes the related taxes (requires inclusion of proper language in the divorce papers).
Achieving Equitable and Tax-Effective Property Splits		
______	1.	Make sure property will be split between the parties based on after-tax values.
______	2.	Consider taking advantage of the IRC Section 1041(a) tax-free transfer rule to structure postdivorce property transfers that address cash flow needs and save on taxes (generally, tax-free postdivorce transfers can occur within one year or six years if required under the divorce instrument).
Children's Exemptions		
______	1.	If the client's ex-spouse is to release the children's dependent exemption(s) to the client, make sure a signed Form 8332 (Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent) is obtained from the other party at the time the other divorce papers are executed. A separate form is required for each exemption.
______	2.	Note that Form 8332 can be completed to release the exemption(s) for one year, for specified years, for alternating years, or forever. Make sure the form releases the exemption(s) for the proper years.
Making Sure Payments Qualify as Alimony as Anticipated		
______	1.	Prior to their execution, review the divorce papers and complete the checklist in practice aid 6-5 to avoid problems that would reduce the client's alimony deductions.
______	2.	Prior to their execution, review the divorce papers and complete the worksheet in IRS Publication 504, *Divorce and Separated Individuals*, to make sure the client will not have unanticipated alimony recapture problems.

Practice Aid 6-2: Client Letter Regarding Separate Returns

Explanation: This letter is intended for clients who are either separated or in the process of getting divorced. The issue discussed is the filing status that will be used for yet-to-be filed federal income tax returns.

Dear Client:

As we have discussed, several significant federal income tax considerations are associated with your impending divorce [*modify language if client is just separated*].

One important issue is how you and your spouse will file your federal income tax returns for [*insert year*]. Because you were [*will be*] still married at year-end, you have the option of filing a joint return or separate returns.

The major advantage to you of filing separate returns is that you would not be financially responsible if it is later discovered that there is an unpaid tax liability caused by your spouse's actions. In contrast, if you file a joint return for the year, the IRS could initiate collection actions against you if, for example, your spouse fails to report income, overstates deductions, or fails to make required tax payments.

Your filing status decision will also affect the amount of your tax bill or refund for the year. Depending on various factors, there may be a greater or lesser combined tax liability from filing joint or separate returns.

We are available to assist you in evaluating all the implications of filing joint or separate returns. Please give us a call if you have questions or want additional information.

Very truly yours,

Practice Aid 6-3: Client Letter Regarding Timing of Divorce

Explanation: This letter is intended for clients who can potentially arrange for their divorce to become final this year or next year. The issue is whether there is a tax advantage to having the divorce occur in the earlier or later year.

Dear Client:

Per our discussions, it appears possible at this point that your impending divorce could be finalized either shortly before year-end or early next year. If the divorce occurs this year, you and your spouse will be single at year-end and accordingly can file separate returns as single taxpayers for the entire year.

If you remain married through year-end, you can file jointly or using married filing separate status [*insert language if head of household status will be available to one or both spouses*].

Based on the filing status options available to you and your spouse and the rules regarding allocation of income and deduction items and tax payments, the timing of the divorce could have a significant impact on the tax liability for this year.

Also, if you remain married through year-end and choose to file a joint return, be aware that you could be financially responsible if it is later discovered that there is an unpaid tax liability. The IRS could initiate collection actions against you if, for example, your spouse fails to report income, overstates deductions, or fails to make required tax payments and you are aware of the situation. (If you remain married through year-end and file separate returns, you are not financially responsible for any unpaid tax liability related to your spouse's income, deductions, or tax payment obligations.)

We are available to assist you in evaluating all the tax implications associated with the timing of the divorce. Please give us a call if you have questions or want additional information.

Very truly yours,

Practice Aid 6-4: Letter to Attorney Contacts Regarding Dividing Individual Retirement Accounts and Qualified Retirement Plan Assets

Explanation: This letter is intended to notify your domestic relations attorney contacts that you are available to consult with them in drafting divorce documents that avoid the tax problems that can occur when individual retirement account and qualified retirement plan assets are split. The letter can also be modified to make the same offer to divorce attorneys engaged by your existing clients.

Dear Attorney:

As you know, divorces have a number of important federal income tax implications. The various tax issues are often not clearly understood by clients. Often, careful drafting of divorce documents is critical to achieve equitable tax results for the parties.

This is especially true when property settlements involve divisions of individual retirement account or qualified retirement plan account assets. Without advance planning and compliance with detailed Internal Revenue Code requirements, the situation can easily arise in which one former spouse receives retirement account funds while the other turns out to owe the related federal income taxes. Of course, this is rarely what a divorcing couple actually intends to happen.

Please contact me if I can be of assistance in consulting with you to help ensure that the tax ramifications of divorce settlements are consistent with your client's needs and expectations.

Very truly yours,

Practice Aid 6-5: Checklist to Make Sure Payments Qualify as Deductible Alimony

Explanation: This checklist asks for responses to a number of questions regarding payments from one ex-spouse to the other. All questions must be answered "True" in order for payments to qualify as deductible alimony. "False" responses indicate that divorce documents may have to be modified for the client to be able to deduct the full amount of payments as alimony.

_______	1.	Amount is required to be paid pursuant to a divorce decree, separate maintenance decree, written separation agreement, or other written court order or decree.
_______	2.	Amount was not paid before there was a legal requirement to do so under one of the decrees or agreements in item 1 and was not in excess of what was required under one of the decrees or agreements in item 1.
_______	3.	For amounts paid under final divorce or separate maintenance decrees, the parties lived in separate households at the time payments were made.
_______	4.	Divorce papers do not refer to amounts intended to be alimony as not being alimony.
_______	5.	The amount was paid in cash or by check or money order.
_______	6.	Payments to third parties were pursuant to terms of divorce instrument or at written request of or with written consent of payee. If under written request or by consent, payer has the document before filing tax return and document states amounts were intended as alimony.
_______	7.	Payments cease upon death of payee (under terms of divorce papers or by virtue of state law).
_______	8.	There is no acceleration clause for payments upon death of payee that effectively cause all payments to be due whether or not payee lives.
_______	9.	Payments are not stated in the divorce papers to be for child support.
_______	10.	Payments are not deemed to be for child support under the child contingency rules.
_______	11.	Payments are not deemed to be for child support under the first or second clearly associated child contingency rules.
_______	12.	The payments during the first three years have been tested under the alimony recapture rules and there is no recapture, or the amount expected to qualify as alimony has been reduced by the recapture amounts.

7

Tips for Self-Employment Clients

Introduction

For purposes of this chapter, *self-employed* means the status of essentially working for oneself. This may be done via a sole proprietorship, a solely owned C or S corporation (or a corporation with only a few shareholders), a single-member limited liability company (LLC), or a partnership (or multi-member LLC) composed of only a few owners.

Unfortunately, the tax advantages of self-employment (SE) are often overstated. When clients initially enter the SE arena, they may have unrealistic visions of deducting enormous retirement plan contributions, deducting 100 percent of their auto expenses and 50 percent of the cost of entertaining themselves and their friends, and so forth and so on.

In reality, self-employed individuals *are* eligible for some decent tax breaks, but they also face some unfavorable (some would say downright unfair) tax rules when it comes to the SE tax. This chapter presents some planning ideas to maximize the advantages of self-employed status, while minimizing the disadvantages.

Choice of Business Entity

When a new business venture is contemplated or when an existing activity reaches a certain level of size and profitability, an important consideration is choosing the type of legal entity that will be used to conduct the activity. This is often referred to as the *choice of entity* decision.

The choice of entity landscape has been dramatically altered by three relatively recent developments:

- Passage of LLC acts in all 50 states plus the District of Columbia (LLCs are probably now the *preferred* entity choice for closely held businesses.)
- Emergence of limited liability partnerships (LLPs), which can be attractive for professional service businesses
- Release of the so-called check-the-box entity classification regulations, which make it easy to ensure partnership tax classification for multi-owner unincorporated entities and which allow very favorable tax treatment for single-member LLCs

The following sections give some "quick and dirty" guidance on the choice of entity decision process.

Sole Proprietorships

The major attraction of sole proprietorships is administrative simplicity. Because a sole proprietorship is owned by a single individual and is not considered a separate entity (for either tax or legal purposes), there are no federal income tax complexities. The owner simply files Schedules C and SE with his or her Form 1040 (U.S. Individual Income Tax Return).

As soon as a business begins to generate significant income and wealth for the owner, the use of a liability-limiting entity (corporation, LLC, LLP, or limited partnership) is highly advisable. However, the LLP and partnership options are not available to single-owner businesses (a partnership by definition must have at least two owners).

Almost all states now allow single-member LLCs (LLC owners are referred to as *members*). In those states that do not, however, the only liability-limiting entities available to single-owner businesses are C and S corporations.

Recommendation

The sole proprietorship may be the preferred form of doing business when all of the following conditions exist

- there is only a single owner and
  - — adequate liability insurance is available at an acceptable cost or
  - — major liability exposures are from the owner's practice of a profession (a problem that is generally *not cured* by a liability-limiting entity);
- the business is in the early stages, and minimizing administrative expenses and paperwork is a major objective;
- the owner does not wish to currently deal with the issue of how future transfers of ownership interests (for estate planning, succession planning, or other reasons) will be accomplished;
- the owner does not wish to deal currently with the issue of how additional equity capital might be raised in the future; and
- the business is currently small enough that operating as a sole proprietorship is still a rational choice in light of all the considerations in this list.

Single-Member LLCs

Multi-member LLCs are allowed in all 50 states and the District of Columbia. Multi-member LLCs qualify for the favorable partnership taxation rules. Single-member LLCs, which are entities with only one owner (member), are also generally allowed.

Pursuant to the check-the-box entity classification regulations,[1] the existence of single-member LLCs is generally ignored for federal tax purposes. Therefore, when a single-member LLC is owned by an individual and used to conduct a trade or business activity, the tax

[1] Treas. Regs. 301.7701-1, -2, and -3.

information will be reported on Schedule C of the owner's Form 1040 and the owner will complete Schedule SE to calculate his or her SE tax. In other words, the tax treatment of a single-member LLC's business is exactly the same as for a sole proprietorship.

If the LLC is used to operate a rental real estate operation, the tax information will be reported on the owner's Schedule E.

Although the single-member LLC will be *invisible* for federal tax purposes, it should still protect the owner's personal assets from business-related liabilities as long as the applicable LLC statute is complied with. This liability protection will be similar to that offered by a corporation.

Recommendation

When available, single-member LLCs are usually the best choice for single-owner businesses because they

- provide liability protection,
- are not subject to double taxation, and
- are extremely simple from a federal tax compliance standpoint.

Warning: Before concluding that single-member LLC status is a "no brainer" choice for clients currently operating as sole proprietorships, be sure to carefully examine the state tax implications. For example, although Texas allows single-member LLCs, they are subject to the state's corporate franchise tax, but sole proprietorships are not. However, in Colorado, for example, single-member LLCs are not subject to any additional entity-level taxes.

S Corporations

Legally, S corporations and C corporations are identical. The only difference is their treatment under the tax rules. Corporations offer the greatest certainty in terms of protecting the personal assets of owners from the risks of the business. A corporation is treated as a distinct legal entity separate and apart from its shareholders. Therefore, the corporation owns its own assets and is liable for its own debts. As a result, the personal assets of shareholders (including shareholder-employees) are generally beyond the reach of corporate creditors.

Shareholders generally remain *exposed* to corporate liabilities resulting from their own tortious acts and their own professional errors and omissions. Also, shareholders may be required on occasion to personally guarantee certain of the corporation's debts as a condition of obtaining financing or for other reasons, and they are personally obligated with respect to corporate debts that are specifically guaranteed.

The *only* difference between S and C corporations is the tax treatment. S corporations qualify for the generally preferred single level of federal income taxes at the shareholder level (so-called pass-through taxation). In contrast, C corporation taxable income is taxed once at the corporate level and again at the shareholder level when passed out in the form of dividends.

The election of S corporation status is made by filing Form 2553 (Election by a Small Business Corporation). The form can be filed during the preceding tax year for an election to become effective for the following tax year. For an S election to be effective for the *current* tax year, it must be filed by the fifteenth day of the third month of that year.

Newly formed corporations generally intend for the election of S status be effective for the initial tax year. The election must be filed by the fifteenth day of the third month after the *activation date* of the corporation. This is the earliest date the corporation has shareholders, acquires assets, or begins conducting business.

> **Key Point:** As explained later in this chapter, some tax advisers advocate S corporation status rather than LLC or partnership status, mainly because S corporations can be used to minimize Social Security and Medicare taxes.

Special Restrictions on S Corporations

To qualify for the benefits of pass-through taxation, S corporations must meet a number of strict eligibility rules. Unfortunately, these rules greatly restrict stock ownership and capital structure possibilities and can therefore make operating as an S corporation much less attractive than it first appears. If the eligibility rules are not met at any time during the tax year, the S status of the corporation is immediately terminated and the corporation falls under the C corporation taxation rules.

Qualifications

To qualify for S status a corporation must

- be a domestic corporation;
- have no more than 100 shareholders;
- have no shareholders other than individuals who are U.S. citizens or resident aliens, estates, and certain types of trusts or tax-exempt entities; and
- have only one class of stock (issuing voting and nonvoting shares is permitted, but there can be no preferred stock or common stock classes with differing economic characteristics).

These restrictions can hamper attempts to raise capital and may frustrate plans to transfer stock for income tax planning, estate planning, and business succession reasons.

Ineligible Corporations

The following types of corporations are ineligible for S status by definition:

- Financial institutions allowed to deduct bad debts under Internal Revenue Code (IRC) Section 585
- Domestic international sales corporations (DISCs) or former DISCs
- Insurance companies other than certain casualty companies
- Certain corporations electing to take the possessions tax credit

Recommendation

In general, S corporations may be preferred to sole proprietorships and the other entity choices when all of the following conditions exist:

- Limiting owner liability is a critical concern.
- Pass-through taxation is desired.
- S corporation eligibility rules can be met without undue hardship.
- Restrictions on eligible S shareholders do not cause undue hardship with regard to the owners' future plans to transfer ownership interests to others for estate planning, family tax planning, or business succession planning purposes.
- There will be only one owner (making partnership taxation unavailable by definition) and single-member LLC status is not available, or there will be two or more owners and
  - activity cannot be operated as a multi-member LLC under state law, applicable professional standards, or both or because the owners cannot live with the legal uncertainties associated with LLC status;
  - activity cannot be operated as a limited partnership because the owners who would be limited partners cannot live with the fact that they must avoid management involvement to maintain their limited liability protection; *and*
  - business either cannot be operated as an LLP, or the liability protections offered by LLPs are considered inadequate.

Some key additional points to consider:

- Assessing the attractiveness of S corporations involves balancing the advantages of superior liability protection for owners and pass-through taxation against the negative implications of the restrictive eligibility rules.
- Most tax advisers agree that LLCs and limited partnerships are superior to S corporations.
- However, when there is only a single owner and double taxation must be avoided, the S corporation is the only alternative to sole-proprietorship status in states that do not permit single-member LLCs for the type of business in question.

Regular Corporations (C Corporations)

The principal advantage of C corporations is their ability to protect owners from liabilities related to the business. A C corporation may also be able to offer more tax-favored fringe benefits to its owner(s) than the other entities discussed in this section. As discussed earlier in this chapter, the liability-limiting attributes of C and S corporations are identical.

Disadvantages

The key disadvantage of C corporations is that they are subject to double taxation. The double taxation issue appears in several different ways, which are briefly described as follows:

- *Dividend distributions.* If the corporation has accumulated earnings and profits, non-liquidating distributions to shareholders are treated as dividends. These are taxed to the recipient shareholders, but the payments are not deductible by the corporation. In some situations, the corporation may be forced to make dividend distributions to avoid being hit with corporate-level penalty taxes on excessive retained earnings.
- *Double taxation on sale of stock.* When a C corporation earns taxable income, there is no upward adjustment in the tax basis of the shareholders' stock. The retained income increases the value of the stock, which creates a bigger capital gain when shares are eventually sold. As a result, the retained income is, in effect, taxed again when shares are sold.
- *Double taxation on liquidation.* If the corporation holds appreciated property and eventually liquidates, the property to be distributed in liquidation is treated as sold by the corporation for its fair market value (FMV). The corporation must then pay the resulting taxes. When the corporate assets, net of corporate-level taxes, are distributed to shareholders in liquidation, shareholders must also recognize taxable gain to the extent the FMV of the liquidating distributions exceeds the tax basis of their shares. Double taxation also occurs if the corporation sells its assets and distributes the sales proceeds in complete liquidation.
- *Double taxation of appreciating assets.* If the corporation holds appreciating assets, the resulting gains will be subject to double taxation if they are sold by the corporation, if the corporation is liquidated, or if the corporate stock is sold. The author strongly recommends that assets expected to appreciate significantly (for example, real estate, patents, copyrights, and so on) be owned by a pass-through entity (which is, in turn, owned by the C corporation's shareholders). The pass-through entity can then lease the assets to the C corporation. With this arrangement, the C corporation can reduce its taxable income by making deductible rental payments which benefit its shareholders. And any gains upon the eventual sale of the appreciated assets owned by the pass-through entity will not be subject to double taxation.

Other negative aspects of C corporation taxation apply in the following circumstances:

- When the corporation has significant tax losses, as they cannot be passed through to shareholders and do no good unless the corporation eventually has positive taxable income
- When the corporation has significant long-term capital gains, capital losses, or tax-exempt income (capital gains are taxed at the same rate as ordinary income, capital losses can only be used to offset capital gains, and tax-exempt income gets taxed when the stock is sold to the extent it increases the stock's value)

There are also certain situations in which the C corporation tax provisions are *more* favorable than the rules applying to pass-through entities (such as application of the passive loss rules and the Federal Insurance Contributions Act tax treatment that applies to shareholder-employees).

When Are the Corporate Tax Rules Harmless or Even Favorable?

Corporations can often solve the double taxation problem by *zeroing out* corporate income with deductible payments to or for the benefit of shareholder-employees. Such payments can be for salary, fringe benefits, interest on shareholder loans, and rent for property owned by shareholders. When corporate income can be zeroed out, the issue of double taxation is not applicable.

Even when zeroing out income is not possible, the favorable graduated corporate tax rates can make C corporations attractive compared to pass-through entities. This is the case when businesses earn relatively small amounts and intend to indefinitely retain all earnings in order to internally finance their growth. A pass-through entity might have to distribute up to 35 percent of the taxable income earned by the business just to enable the owners to pay their personal federal income taxes (for 2012), whereas the average tax rate on the first $75,000 of corporate income is only 18.33 percent.

As a result, the use of a C corporation can maximize the current cash flow of the business. It must be remembered, however, that the cost of this current benefit is the potential double taxation that may apply in later years.

Example 7-1

Steve is acquiring a new business expected to generate taxable income of $50,000 per year. Steve intends to operate the venture for 7 years and then sell out, using the proceeds to help finance his retirement.

Steve has large amounts of income from his other interests. Therefore, the incremental income from the business will be taxed at 35 percent if a sole proprietorship or pass-through entity is used. However, if Steve forms a C corporation to operate the business, the corporate tax rate on projected taxable income will be only 15 percent.

For choice-of-entity evaluation purposes, the corporation's retained after-tax income adds to the value of its stock dollar for dollar. Further, after 7 years, Steve will pay a 15 percent long-term capital gains tax on this increase in the value of the corporation's stock. This amounts to an effective shareholder-level tax rate of 12.75 percent (15 percent of the 85 percent of corporate income left after corporate-level taxes). The shareholder-level tax is in addition to the corporate-level tax of 15 percent. Therefore, the combined shareholder-level and corporate-level tax bite is only 27.75 percent (12.75 percent plus 15 percent). This is lower than the 35 percent rate that would apply with a sole proprietorship or pass-through entity.

In addition, note that when a C corporation is used, the shareholder-level tax (the 12.75 percent piece in this example) is deferred until Steve sells his stock. In contrast, the full 35 percent tax bite is due annually if a C corporation is not used.

This example illustrates the benefits of splitting income with a C corporation and thereby taking advantage of the favorable graduated corporate tax rates. The positive effect of splitting income can

overwhelm the negative effect of double taxation if the shareholder's marginal tax rate is high and the corporation's taxable income is relatively low.

If Steve's company meets the definition of a qualified small business corporation (QSBC), he may be able to exclude 50 percent, 75 percent, or even 100 percent of the capital gain on the sale of his shares or roll the gain over on a tax-deferred basis.

Finally, if Steve never draws any salary from the corporation, there will be no federal employment tax liability. However, if Steve is a sole proprietor or general partner in the same business, he may owe significant amounts of SE tax even if no funds are withdrawn from the venture.

> **Key Point:** The author believes that there will continue to be significant gaps between ordinary income tax rates and long-term capital gains tax rates. Assuming that prediction pans out, arranging to have long-term gains instead of ordinary income will continue to be an important tax planning goal, even though the tax rates for 2013 and beyond may be different than the current rates.

> **Warning:** Personal service corporations (PSCs) are ineligible for the favorable corporate graduated tax rates. Instead, all PSC income is taxed at a flat 35 percent rate (through 2012). In addition, other unfavorable tax rules may apply to PSCs.

C corporations are sometimes underrated because of the issue of double taxation. However, the differences between corporate and individual tax rates mean that pass-through taxation often results in higher current outlays for federal income taxes. Recent empirical evidence shows that C corporations are still being formed to operate capital intensive and growth businesses, such as manufacturing and high-tech ventures. Such businesses typically need to retain all earnings to finance capital expenditures and growing receivable and inventory levels. Operating as C corporations maximizes cash flow by minimizing current outlays for federal income taxes. And for very successful businesses, the C corporation format lays the best groundwork for going public.

In contrast, businesses that distribute essentially all of their income to owners should generally be operated via one of the pass-through entities to prevent double taxation from coming into play.

Recommendation

C corporations may be preferred to sole proprietorships and the other entity choices when all of the following conditions exist:

- Limiting owner liability is a critical concern.
- There will be only one owner (making partnership taxation unavailable by definition) and the S corporation restrictions make operating as an S corporation difficult or impossible.
- Single-member LLC status is unavailable, or the activity has two or more owners *and*
  - — it cannot be operated as a multi-member LLC under state law, applicable professional standards, or both or because the owners cannot live with the legal uncertainties associated with LLC status;

— it cannot be operated as a limited partnership because the owners who would be limited partners cannot live with the fact that they must avoid management involvement to maintain their limited liability protection; *and*
— the business either cannot be operated as an LLP, or the liability protections offered by LLPs are considered inadequate; *or*

benefits of pass-through taxation are not required, because the graduated corporate rates counteract the ill effects of double taxation or because the venture's income can be drained off with deductible payments to or for the benefit of the owners.

Qualified Small Business Corporations

If a C corporation meets the definition of a QSBC, shareholders (other than C corporations) are potentially eligible to exclude from taxation up to 50 percent, 75 percent, or even 100 percent of their gains on sale of the corporation's stock. (The gain exclusion rules are fully explained in chapter 1, "Maximizing Tax Benefits for Sales of Capital Gain Assets and Real Property.")

As discussed subsequently, a number of restrictive rules must be met for a corporation to qualify for QSBC status, and shareholders must own their stock for more than *five* years to benefit from the gain exclusion provision.

As explained in chapter 1, sellers of QSBC stock may also be able to roll over their stock sale gains by investing the sales proceeds in newly issued stock of another QSBC. In some cases, this is actually a more valuable benefit than the gain exclusion break.

Note: QSBCs are treated the same as *regular* C corporations for all other tax and legal purposes.

Shareholder Qualification Rules

IRC Section 1202 permits taxpayers other than C corporations who hold QSBC stock for more than 5 years to exclude from taxable income up to 50 percent, 75 percent, or 100 percent of any eligible gain realized on the sale or exchange of such stock. (The taxable part of the eligible gain (either 50 percent of 25 percent) is subject to tax at a maximum rate of 28 percent, and any additional gain qualifies for the 15 percent maximum rate (through 2012) on long-term gains.)

Requirements

The stock must constitute *eligible stock* by meeting all of the following requirements:

- Stock must be acquired by the taxpayer after August 10, 1993.
- Taxpayer must generally acquire the stock upon its original issuance (either directly or through an underwriter) or through gift or inheritance.
- Stock must be acquired in exchange for money, other property (not including stock), or services (not including services performed as an underwriter).

Corporate Qualification Rules

In order for the 50 percent, 75 percent, or 100 percent gain exclusion to be available, the corporation must be a QSBC at the date of the stock issuance and during substantially all the period the taxpayer holds the stock. The following requirements must be satisfied in order for a corporation to constitute a QSBC:

- It must be a C corporation.
- It cannot be
  - a DISC or a former DISC,
  - an IRC Section 936 corporation or a corporation with an IRC Section 936 subsidiary,
  - a regulated investment company,
  - a real estate investment trust,
  - a real estate mortgage investment conduit, or
  - a cooperative.
- It cannot own either
  - real property with a value that exceeds 10 percent of its total assets or
  - portfolio stock or securities with a value that exceeds 10 percent of its net worth.

Active Business Requirement

To be a QSBC, the corporation must also satisfy an active business requirement. The active business requirement is deemed satisfied if either

- the corporation is a specialized small business investment company licensed by the Small Business Administration (unlikely) or
- at least 80 percent, by value, of the corporation's assets, including intangible assets, are used by the corporation in the active conduct of a qualified trade or business.

For this purpose, qualified businesses do not include any of the following:

- Performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business in which the principal asset is the reputation or skill of one or more of its employees
- Banking, insurance, leasing, financing, investing, or similar activities
- Farming
- Production or extraction of oil or gas or other natural resources
- Operation of a hotel, motel, restaurant, or similar business

Finally, the corporation's gross assets cannot exceed $50 million on the date of the stock issuance. For purposes of this rule, the values of the corporation's assets are generally based on their adjusted bases to the corporation. However, contributed property is valued at FMV at

the time of its contribution. If a corporation meets the gross assets test on the date of a stock issuance, a subsequent increase in the value of its assets will not cause this test to be failed. Conversely, once the $50 million threshold is exceeded, the corporation can never again be a QSBC, even if its assets subsequently fall below $50 million.

Recommendation

C corporations meeting the definition of a QSBC may be preferred to sole proprietorships and the other entity choices in the same circumstances as C corporations as discussed earlier in this chapter (the QSBC tax breaks should be considered a bonus). The same applies to QSBCs, except that QSBCs are somewhat more attractive than *regular* C corporations because of the 50 percent, 75 percent, or 100 percent gain exclusion and gain rollover tax breaks.

Multi-Member LLCs

Multi-member LLCs are popular because they combine the best legal and tax characteristics of corporations and partnerships, while avoiding many of their disadvantages. Specifically, a multi-member LLC can offer limited liability protection to all its owners (referred to as *members*), while being treated as a partnership for federal income tax purposes. Multi-member LLCs are now available in all 50 states and the District of Columbia.

Legal Considerations

LLCs are unincorporated legal entities created under state law. Even though multi-member LLCs are unincorporated vehicles, the fundamental intent of LLC statutes is to allow the formation of entities that are more legally similar to corporations than partnerships.

Nevertheless, multi-member LLCs can be taxed as partnerships. The critical point to remember is that, legally, LLCs are *not* corporations, nor are they partnerships. Although the personal assets of LLC members and managers are protected from *general* LLC debts and obligations (often referred to as *contract liabilities*), these persons generally remain *exposed* to LLC liabilities resulting from their own tortious acts and their own professional errors and omissions. (*Tortious acts* are defined as wrongful acts leading to civil actions other than those involving breach of contract.)

The issue of members' and managers' exposure to liabilities related to tortious acts and professional errors and omissions is a matter of state law. Consult an attorney regarding specific questions.

As is the case with corporate shareholders, LLC members may be required on occasion to personally guarantee certain of the entity's debts as a condition of obtaining financing or for other reasons. Members are personally obligated with respect to LLC debts that are specifically guaranteed.

Tax Treatment of Multi-Member LLCs

The key *tax* attribute of multi-member LLCs is that they can be treated as partnerships for federal income tax purposes. The tax advantages of partnership status are covered later in this chapter.

Conclusions on Multi-Member LLCs

Because LLC laws are still relatively new, inevitable legal uncertainties are associated with making the choice to operate as an LLC rather than as a partnership or as a C or S corporation. There are also some unanswered questions regarding how certain federal tax law provisions apply to LLCs. Commentators feel these uncertainties are the major disadvantage of LLCs.

However, only multi-member LLCs are able to offer both the legal advantage of limited liability for all owners and the tax advantage of partnership taxation, which combines pass-through treatment with maximum flexibility. This unique combination of legal and tax benefits is the driving force behind the growing use of LLCs.

When Should an LLC Be Used?

Multi-member LLCs are suitable for many business and investment activities including, but not limited to, the following:

- Real estate investment and development activities, because the partnership taxation rules allow investors to obtain basis from entity-level debt and special tax allocations can be made to investors
- Oil and gas exploration when the partnership rules can be used to make special allocations of intangible drilling cost deductions to investors
- Venture capital investments when the partnership rules allow pass-through taxation and the creation of *customized* ownership interests with varying rights to cash flow, liquidating distributions, and tax items
- Business start-ups expected to have tax losses in the initial years which can be passed through to investors
- Professional practices, if allowed under state law and applicable professional standards when pass-through taxation can be combined with specially tailored ownership interests that reflect each member's contributions to the practice

Under some state laws, applicable professional standards (such as state bar association rules), or both, LLCs may be prohibited from operating certain professional practices. However, when permitted, LLCs are an excellent choice. Professional LLCs may offer better liability protection than LLPs, depending on state law. And the ability to create differing types of LLC ownership interests (for example, to reflect the activity levels of the members) can often be attractive to professional groups.

Some states do not permit the use of LLCs in certain lines of business, such as banking, insurance, and farming.

According to one survey, the top 10 types of businesses actually operated as LLCs are as follows:

1. Engineering and management support services (26 percent)
2. Real estate services (19 percent)
3. Construction and general contracting (12 percent)
4. Investment companies (9 percent)
5. Retailers (8 percent)
6. Health services (7 percent)
7. Agriculture (7 percent)
8. Oil and gas extraction (2 percent)
9. Restaurants (2 percent)
10. Leasing companies (2 percent)

Recommendation

Most advisers agree that the multi-member LLC is the best entity alternative for businesses with several owners if pass-through taxation is desired such as with a service business that does not need to retain significant amounts of earnings within the business entity.

However, empirical evidence shows that multi-member LLCs are seldom formed to operate capital-intensive and high-growth businesses, such as manufacturing and high-tech ventures. Such businesses typically need to retain all earnings to finance capital expenditures and growing receivable and inventory levels. These businesses are most often operated as C corporations in order to maximize cash flow by minimizing current outlays for federal income taxes.

Because multi-member LLCs allow all members to fully participate in management without risk of losing limited liability protection, which can happen with a limited partnership, they are ideally suited for closely held entrepreneurial businesses.

In summary, multi-member LLCs may be the best choice for business and investment when all of the following conditions exist:

- There will be more than one owner.
- Limited liability protection for the co-owners is an important consideration.
- Pass-through taxation is desired.
- Advantages of partnership taxation are significant compared to the alternative of S corporation taxation, or the entity cannot qualify for S corporation status.
- Business (or investment) activity can be operated as an LLC under state law.

Limited Liability Partnerships

LLPs are a relatively new type of entity that can be particularly useful for the operation of professional practices. LLPs are formed and operated pursuant to state LLP statutes. LLPs are now available in all 50 states.

Liability of LLP Partners

In some states, LLPs are in essence a special form of general partnership. Like general partners, LLP partners in these states remain personally liable for the general debts and obligations of the LLP (contract liabilities). Contract liabilities include bank loans, lease obligations, vendor accounts payable, and so on. However, LLP partners are generally *not* liable for the professional errors and omissions of the other LLP partners and employees.

In most states, however, LLP partners are protected from exposure to the LLP's contract liabilities unless they are expressly guaranteed by the partners. In other words, most states offer *LLC-like* liability protection to LLP partners.

In all states, an LLP partner generally remains personally liable for his or her own tortious acts and his or her own professional errors and omissions and possibly for errors and omissions of other individuals who were or should have been supervised by that partner.

The issue of LLP partners' exposure to liabilities related to professional errors and omissions is a matter of state law. Consult an attorney regarding specific questions.

LLP Advantages and Disadvantages

LLPs are partnerships both for state law and federal income tax purposes, and they are therefore subject to the legal and tax implications that generally apply to partnerships.

Advantages

The major advantage of LLPs is the ability to benefit from pass-through taxation without being affected by the various restrictions applying to S corporations such as the one-class-of-stock rule and the other limitations discussed earlier in this chapter. In addition, LLPs enjoy the other tax advantages that partnerships have over S corporations.

Disadvantages

In states where LLP partners are not protected against contract liabilities, the principal disadvantage is this lack of *complete* liability protection. In these states, this inferior liability protection makes LLC status much more attractive than LLP status. However, under some state laws and under certain professional standards, the use of LLCs may be prohibited. In such situations, LLPs offer better liability protection than general partnerships and are not burdened with the double taxation problems of C corporations.

In states where LLPs are afforded LLC-like liability protection, LLPs have no real disadvantages.

Update on Status of LLP Members for SE Tax Purposes

Because the IRC's SE tax provisions were enacted long before the existence of LLPs, there are many questions about how to apply the SE tax rules to LLP partners. A 2011 U.S. Tax Court decision (*Renkemeyer, Campbell & Weaver, LLP*) delivers some much-needed clarity, although it is not taxpayer-friendly news. According to the Tax Court, the active partners in a Kansas law firm LLP were subject to SE tax on their shares of the LLP's net income.

Self-Employment Tax Considerations

To understand the SE tax issue for LLP partners, it is important to understand the long-standing special SE tax rule for limited partners. Under that special rule, a *limited partner* includes in his or her SE income only guaranteed payments from the partnership for services rendered to the partnership. Such guaranteed payments are determined without regard to the partnership's income and are often called "partner salaries." The special SE tax rule is beneficial to limited partners because they typically do not receive any partner salaries and, therefore, typically do not owe any SE tax on their shares of partnership income.[2]

In contrast, a *general partner* must include his or her share of the partnership's net income from business activities in SE income. Therefore, general partners usually owe SE tax on their shares of net partnership income.[3]

The favorable special SE tax rule for limited partners was enacted long before LLPs existed. So how do LLP partners deal with the SE tax issue? Can they claim they are limited partners for SE tax purposes because they are not personally liable for the LLP's debts? If the answer is yes, they could avoid the SE tax by simply not taking any partner salaries. Instead, they could take random SE-tax-free distributions to collect their shares of the LLP's cash flow. Basically, that was the argument made by the Kansas law firm partners in *Renkemeyer, Campbell & Weaver, LLP*. Unfortunately, the Tax Court did not buy it.

Tax Court Decision States Active LLP Partners Are Not Limited Partners for SE Tax Purposes

The Tax Court opined that LLP members who are active in the entity's business should not be treated as limited partners for SE tax purposes, because the "active factor" is more important than the "limited liability factor."

In reaching this conclusion, the Tax Court looked at the legislative history of the special SE tax rule for limited partners, which was enacted as part of the Social Security Amendments of 1977 (Public Law 95-216). The legislative history states that the intent of Congress was to exclude, for Social Security benefits eligibility purposes, income received by a limited partner that is "of an investment nature." Consistent with that intent, the special limited partner rule made such income exempt from the SE tax.

The shares of income received by the partners in *Renkemeyer, Campbell & Weaver, LLP,* were clearly not earnings "of an investment nature." Instead, they were earnings from actively participating in the law firm's business. Therefore, the Tax Court stated that the special SE tax rule for limited partners was inapplicable, and the LLP partners owed the SE tax.

In addition, the Tax Court observed that a limited partner is, by definition, a member of a limited partnership. In contrast, an LLP partner is basically a member of a special category of general partnership established under the applicable state LLP statute. This consideration gave further weight to the conclusion that an active LLP partner's earnings cannot be sheltered from the SE tax by the special limited partner rule.[4]

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[2] See Internal Revenue Code (IRC) sec. 1402(a)(13).

[3] See IRC sec. 1402(a).

[4] See *Renkemeyer, Campbell & Weaver, LLP,* 136 TC No. 7 (2011).

Recommendation

LLPs are probably the best entity choice for professional service ventures when all of the following conditions exist:

- There are several owners.
- Pass-through taxation is desired.
- LLP status affords LLC-like liability protection.
- LLP status is permitted under the statute and applicable professional standards, or state law does not afford LLC-like liability protection, but
  - — qualifying as an S corporation would be inconvenient, difficult, or impossible, and
  - — co-owners can live with their exposure to the entity's contract liabilities.

In many cases, professional practices can be operated as C corporations and avoid the double taxation problem by *zeroing out* corporate income with deductible payments to or for the benefit of the owners. When this is possible, C corporations are probably a better choice than LLPs when LLPs are not afforded LLC-like liability protection.

General Partnerships

The partners of a general partnership are personally liable (without limitation) for all debts and obligations of the partnership. The liability of general partners is *joint and several* in nature. This means any one of the general partners can potentially be forced to make good on all partnership liabilities. That partner may be able to seek reimbursement from the partnership for payments in excess of his or her share of liabilities, depending on the ability of the other partners to contribute funds to allow the partnership to make such reimbursement.

Some key points to consider for general partnerships are:

- General partners are jointly and severally liable for partnership liabilities related to the tortious acts and professional errors and omissions of the other general partners and the partnership's employees.
- In addition, general partners are personally liable for their own tortious acts and professional errors and omissions.

Finally, each general partner usually has the power to act as an agent of the partnership and enter into contracts that are legally binding on the partnership and ultimately on the other partners. For example, a partner can enter into a lease arrangement that is legally binding on the partnership. For this reason, it is critical that the partners have a high degree of trust in each other. If that is *not* the case, a general partnership is inadvisable.

Advantages of Pass-Through Taxation

Obviously, the major advantage of general partnerships is their ability to benefit from pass-through taxation without being affected by the various restrictions applying to S corporations.

The major features of pass-through taxation are described as follows:

- *Partnerships are not taxpaying entities.* Instead, the partnership's items of income, gain, deduction, loss, and credit are passed through to the partners, who then take those items into account in their own tax returns.
- *Adjustments can be made to basis in ownership interests.* When the partnership's income and losses are passed through to a partner, his or her basis in his or her partnership interest is adjusted accordingly. Specifically, the partner's basis is increased by his or her passed-through share of income and gains and decreased by his or her share of losses and deductions. This procedure ensures that income is subject to only a single level of taxation, at the partner level.
- *Cash distributions reduce basis in a partner's interest.* Only distributions in excess of basis trigger taxable gain to the partner.

Multi-year Impact of Pass-Through Taxation

The avoidance of double taxation of entity income makes a large (and favorable) difference when an entity earns substantial amounts of taxable income over a period of several years. However, it must be remembered that the C corporation tax rates on the first $75,000 of annual income are considerably lower than the individual tax rates that apply if the same income is passed through by a partnership (or S corporation). Even at higher income levels, the C corporation rates are still lower than the individual rates for high-income individuals. If all income is expected to be retained in the business indefinitely (for example, to finance growing receivable and inventory levels), the more favorable C corporation rates can partially or wholly offset the negative effects of double taxation. In such cases, operating as a C corporation may be preferable to pass-through entity status.

Differences between Partnership and S Corporation Taxation

The previous discussion of pass-through taxation applies equally to partnerships and S corporations. (For S corporations, simply substitute *corporation* and *shareholder* for *partnership* and *partner*, respectively.) However, significant *differences* also exist between partnership and S corporation taxation. Most of these differences are in favor of partnerships, including the following:

- Partners can receive additional tax basis (for loss deduction purposes) from entity-level liabilities, while S corporation shareholders can receive additional tax basis only from loans made by them to the corporation. (Shareholder guarantees of corporate debt have no effect on shareholder basis.)
- Partners who purchase a partnership interest from another partner can step up the tax basis of their shares of partnership assets.
- Partners and partnerships have much greater flexibility to make tax-free transfers of appreciated property between themselves than do S corporations and their shareholders.

- Partnerships can make disproportionate allocations of tax losses and other tax items among the partners. In contrast, all S corporation pass-through items must be allocated among the shareholders strictly in proportion to stock ownership.

Partners' Basis from Partnership Debt

Example 7-2

Steve and Jerry each contribute $40,000 cash to start a 50/50 equipment leasing general partnership. The partnership obtains a $400,000 recourse loan and purchases equipment for that amount.

As 50/50 partners, Steve and Jerry each have initial basis in their partnership interests of $240,000 ($40,000 from the cash contributed plus $200,000 from each partner's share of the partnership's debt) for loss deduction purposes.

If Steve and Jerry each contributed $40,000 to start the business as a 50/50 S corporation, each owner's initial basis for loss deduction purposes would be limited to his $40,000 basis in S corporation stock. Somewhat surprisingly, this is the case even if Steve and Jerry each personally guarantee $200,000 of the corporation's debt.

At-Risk Basis from Partnership Debt

Partners will generally receive IRC Section 465 at-risk basis only from debt for which they are personally liable (in other words, recourse debt or nonrecourse debt that is personally guaranteed). In example 7-2, Steve and Jerry would each have initial at-risk basis in their partnership interests of $240,000. The same would be true if the debt is nonrecourse, but both partners personally guaranteed 50 percent of the debt.

Absent personal guarantees, partners receive IRC Section 465 at-risk basis from partnership *nonrecourse* debt only if it is qualified nonrecourse financing. Therefore, if the partnership has only nonrecourse debt (or the partner is a limited partner), the at-risk limitation rules will often prevent the partner from deducting losses in excess of the basis derived from his or her cash and property contributions to the partnership.

However, example 7-3 illustrates, the *regular* basis from partnership nonrecourse debt can still be very beneficial in eliminating or minimizing current taxable gain when a partner contributes property with debt in excess of basis.

Example 7-3

Huck and Chuck form a 50/50 partnership to develop raw land. In exchange for his partnership interest, Huck contributes land with tax basis of $80,000 and FMV of $200,000. The land is burdened with a $120,000 nonrecourse liability. However, assume the liability is not qualified nonrecourse financing. Chuck contributes $80,000 cash (equal to the value of the equity in the land contributed by Huck).

The partnership agreement provides for 50/50 allocations of all items of taxable income, gain, deduction, and loss, and the basis from the $120,000 of debt is allocated between Huck and Chuck as follows:

1. $40,000 is allocated to Huck. This amount is equal to the deemed built-in gain as of the contribution date (the $40,000 difference between the debt of $120,000 and the tax basis of the property of $80,000).

2. The $80,000 of remaining basis from the debt can be allocated 50/50 between Huck and Chuck, in proportion to their profit sharing percentages.
3. Huck is allocated a total of $80,000 of basis from the debt, and Chuck is allocated $40,000.

Huck will have an initial basis in his partnership interest of $40,000 ($80,000 basis from the contributed land, plus his $80,000 allocation of basis from partnership debt, less $120,000 debt assumed by the partnership). Huck will recognize no gain on his contribution of property with debt in excess of basis.

Chuck will have an initial basis of $120,000 ($80,000 from his cash contribution, plus his $40,000 allocation of basis from partnership debt).

> **Key Points:** If Huck had made the same contribution to an S or C corporation, he would have been required to recognize $40,000 of taxable gain (equal to the excess of the $120,000 of debt assumed by the corporation over the $80,000 basis of the contributed property). Because the partnership's debt is not qualified nonrecourse financing, Huck's initial at-risk basis is zero (the basis of the land, reduced, but not below zero, by the liability assumed by the partnership). However, the fact that the debt added to Huck's *regular* basis prevents the recognition of taxable gain upon his contribution of property with debt in excess of basis. Chuck's initial at-risk basis is limited to his $80,000 cash contribution.

At-Risk Basis from Partnership Qualified Nonrecourse Financing

As stated earlier in this chapter, there is an exception to the general rule that nonguaranteed nonrecourse debt does not add to a partner's at-risk basis. If the debt is qualified nonrecourse financing, each partner's at-risk basis is increased by his allocable share of the debt.

Qualified nonrecourse financing is defined as any loan from a qualified person (or federal, state, or local government) that is incurred by the taxpayer with respect to holding real property and for which no person is personally liable. The loan cannot be convertible debt.[5]

Example 7-4

Sarah and Jessica each contribute $40,000 cash to start a 50/50 real estate acquisition and redevelopment general partnership. The partnership obtains a $400,000 nonrecourse loan, which meets the definition of qualified nonrecourse financing, from the bank and purchases a *fixer-upper* retail strip center for that amount.

As 50/50 partners, Sarah and Jessica each have initial *regular* basis in their partnership interests of $240,000 ($40,000 from the cash contributed plus $200,000 from each partner's share of the nonrecourse debt) for loss deduction purposes.

Because the debt is qualified nonrecourse financing, each partner also has $240,000 of initial at-risk basis for purposes of the IRC Section 465 at-risk limitation rules.

Basis Adjustments When Partnership Interests Change Hands

A unique, and generally favorable, aspect of partnership taxation is that a purchaser of a partnership interest can *step up* the tax basis of his or her share of appreciated partnership assets

[5] See IRC sec. 465 (b)(6).

to reflect the purchase price. This is possible if the partnership makes or has in effect an IRC Section 754 optional basis adjustment election.[6]

If the IRC Section 754 election applies, the purchasing partner's allocations of deductions related to stepped up partnership assets (for example, depreciation deductions) will be based on the higher purchase price rather than on the partnership's lower historical tax basis in the property. Also, if the partnership sells the appreciated property, the purchasing partner's allocation of taxable gain will be smaller because of the partner's stepped up tax basis in his or her share of the property.

No similar basis adjustment mechanism is available to benefit purchasers of S corporation shares.

Example 7-5

Property Owned by Partnership

AB Partnership is a 50/50 joint venture between Alvin and Buxton. The only asset of AB is a patent which is being amortized over 15 years under IRC Section 197. Assume the original cost basis of the patent was $300,000, and cumulative IRC Section 197 amortization is $80,000. Thus, the adjusted tax basis of the patent is now $220,000. The patent has a current FMV of $500,000.

Buxton sells his 50 percent partnership interest to Beverly for $250,000, and the partnership makes an IRC Section 754 election. Accordingly, Beverly's share of the partnership's basis in the patent is stepped up to $250,000 (from the pre-election basis of only $110,000 for Beverly's share) to reflect the purchase price of her partnership interest. Alvin is unaffected by the IRC Section 754 election. After the step-up, the partnership has total tax basis in the patent of $360,000 ($110,000 allocated to Alvin and $250,000 allocated to Beverly).

The partnership now sells the patent for $500,000 and liquidates by distributing $250,000 of cash each to Alvin and Beverly.

With respect to Alvin, the sale generates a taxable gain of $140,000 (his $250,000 share of the proceeds less his $110,000 share of the partnership's basis in the patent). This gain is passed through to Alvin, and increases his basis in his partnership interest. Under IRC Section 1245, $40,000 of the passed-through partnership gain is ordinary income recapture (equal to Alvin's 50 percent share of the $80,000 of IRC Section 197 amortization deductions). The balance is an IRC Section 1231 gain.

Alvin also recognizes gain or loss on the liquidation of his partnership interest equal to the difference (if any) between the liquidation proceeds of $250,000 and his basis in his partnership interest.

With respect to Beverly, the sale generates a taxable gain of zero (her $250,000 share of the proceeds less her $250,000 share of the partnership's basis in the patent). Also, Beverly recognizes no further gain or loss on the liquidation of her interest because the liquidation proceeds of $250,000 and her basis in her partnership interest are equal.

Example 7-6

Property Owned by S Corporation

Use the same facts as in example 7-5, except that now the patent is owned by an S corporation. Beverly buys Buxton's shares for $250,000.

[6] See IRC secs. 743(b) and 754.

There is no mechanism to adjust the inside basis of the entity's assets to reflect what Beverly pays for her 50 percent ownership interest. This causes an *inside/outside basis difference* as explained subsequently.

The patent is sold for $500,000, and the entity is liquidated by distributing $250,000 of cash each to Alvin and Beverly.

At the corporate level, there is a $280,000 taxable gain ($500,000 proceeds less $220,000 basis in the patent). This gain is allocated 50/50 to Alvin and Beverly and increases their basis in their S corporation stock. Under IRC Section 1245, $80,000 of the passed-through gain is ordinary recapture income (equal to the IRC Section 197 amortization deductions). Thus, each owner is passed through $100,000 of IRC Section 1231 gain and $40,000 of ordinary gain.

Alvin will recognize gain or loss on the liquidation transaction (treated as a taxable sale of his stock) equal to the difference (if any) between the liquidation proceeds of $250,000 and his basis in his shares.

Beverly's basis in her shares is $390,000 ($250,000 original purchase price plus $140,000 passed through gain from the patent sale). In Beverly's case, the liquidation transaction generates a capital loss of $140,000 ($250,000 liquidation proceeds less her $390,000 basis in her shares). Thus, from the sale of the patent and the subsequent liquidation of the corporation, Beverly recognizes the following:

- A capital loss of $140,000
- A passed-through IRC Section 1231 gain of $100,000
- An ordinary gain of $40,000

The total gains and losses balance out arithmetically, but the *characters* of the gains and losses are very unfavorable to Beverly.

Conclusions: The problem in this example is caused solely by the difference between inside basis (that is, the basis to the corporation of Beverly's share of the assets) and outside basis (that is, Beverly's basis in her shares). Obviously, the tax results with an S corporation are not nearly as desirable as when the patent was owned by a partnership, when the inside/outside basis problem could be eliminated with an IRC Section 754 election.

Note that in addition to resolving the inside/outside basis problem, an IRC Section 754 election would mean Beverly's IRC Section 197 amortization deductions would be calculated based on her $250,000 share of the partnership's basis in the patent if the partnership continued to hold the patent instead of selling it. As this example illustrates, the ability to make IRC Section 754 elections can be a very significant advantage of partnership taxation over S corporation taxation.

Some cautionary points to consider:

- The IRC Section 754 election must be made by the partnership. It cannot be made by a partner who would benefit from such election.
- Also, once an IRC Section 754 election is made, it is irrevocable without IRS consent.
  - This can be detrimental if the value of partnership property drops.
  - Downward adjustments in basis would then result from subsequent partnership interest purchases, and this would be unfavorable to the purchasing partners.
- Therefore, the IRC Section 754 election should not be made without considering the potential long-range effects on current and future partners.

Not All Partnership Tax Rules Are Favorable

Several disadvantageous tax rules apply to partnerships but not S corporations, such as the IRC Section 708(b)(1)(B) termination rule, the IRC Section 751 *hot assets* rule, and the inclusion of all partnership trade or business pass-through income in the self-employment tax base of partners. However, most tax advisers believe that partnership taxation is clearly more favorable, on an overall basis, than S corporation taxation.

Activities Suitable for General Partnerships

Business and investment activities when general partnerships make sense include, but are not limited to, the following:

- Real estate investment and development activities when the partnership taxation rules allow partners to receive preferred returns, special allocations of tax losses, and additional basis from partnership-level debt
- Oil and gas exploration when the partnership taxation rules allow preferred returns and special allocations of deductions from intangible drilling costs
- Venture capital investments when the partnership rules allow pass-through taxation and the creation of ownership interests with varying rights to cash flow, liquidating distributions, and tax items
- Business start-ups expected to have tax losses in the initial years which can be passed through to the partners
- Professional practices when pass-through taxation can be combined with specially tailored ownership interests that reflect each member's contributions to the practice

Recommendation

General partnerships are probably the best entity choice when all of the following conditions exist:

- There are at least two co-owners, all of whom have a high degree of trust in each other.
- Pass-through taxation is desired.
- LLC, LLP, and limited partnership status are unavailable.
- Liability concerns can be managed with insurance.
- Qualifying as an S corporation would be inconvenient, difficult, *or* impossible, or the entity could qualify as an S corporation, but the benefits of the partnership taxation rules are significant compared to the S corporation taxation rules.

In most cases, the consideration of limiting owner liability is so significant that only a limited partnership, as opposed to a general partnership, will make sense to clients.

In the case of professional practices, operating as an LLC, LLP, or C corporation should be explored. Most advisers agree that general partnerships and sole proprietorships are by far the least attractive entity options.

Limited Partnerships

A *limited partnership* is a separate legal entity, apart from its limited partners, that owns its assets and is liable for its debts. Therefore, the personal assets of the limited partners are generally beyond the reach of partnership creditors. This is the nontax selling point of limited partnerships. Limited partners are, however, still personally responsible for partnership liabilities resulting from their own tortious acts.

The key negative factor associated with limited partnerships is that they must have at least one general partner with unlimited personal exposure to partnership liabilities. Usually this problem can be addressed by forming a corporate general partner. This is often an S corporation jointly owned by the persons who would otherwise function as individual general partners. This strategy effectively limits the amount the general partners can lose to the value of the assets held by the corporation.

Another potentially significant negative factor is that limited partners can lose their limited liability protection by becoming too actively involved in managing the limited partnership. As a result, limited partnerships are not suitable for activities when all partners are heavily involved in the business (for example, professional practices). In some cases, this problem can be avoided by having a corporation owned by the limited partners function as the general partner.

The key tax advantage of limited partnerships is that they can be treated as partnerships for federal income tax purposes.

Taking Advantage of Special Partnership Tax Allocations

The term *special tax allocation* means an allocation of an item of taxable income, gain, loss, deduction, or credit among the owners of a business that is disproportionate to the ownership interests. For example, the allocation of 80 percent of the tax losses to a 25 percent owner is a special tax allocation.

With partnerships, special tax allocations are possible. This is not the case with S corporations, which must pass through all tax items strictly in proportion to stock ownership. Special allocations are often a selling point of limited partnerships.

Generally, a partnership special tax allocation arrangement will work as follows: During the first few years of operation, when tax losses are expected, the losses will be specially allocated to partners who need them. These are usually the so-called *money partners* who supply the initial capital and are passive investors and usually limited partners. The other partners, who are typically active in the operation of the business and function as the general partners, are allocated a disproportionately small amount of the losses in the startup phase. In later years, the partnership is usually expected to generate taxable income or gains. (Otherwise, the partnership was a bad idea to start with.) These will be specially allocated to the limited partners to offset their earlier disproportionate allocations of tax losses. After these allocations of income and gains have *restored* the earlier loss allocations, all partnership tax items are allocated in proportion to the stated ownership percentages, and the special allocation phase of the partnership is over.

On a *cradle to grave* basis, the expectation is that all partners will receive cumulative allocations of taxable losses and income in proportion to their stated ownership interests. Thus, the special allocations simply affect the timing of when losses and income are recognized by the partners.

Substantial Economic Effect Rules

IRC Section 704(b) contains extremely complicated rules that have been promulgated to ensure that partnership tax allocations are not made in an abusive manner. These regulations have come to be known as the *substantial economic effect rules*.

If one cuts through all the complexity of the regulations, they really stand for the simple proposition that partners cannot be allocated tax losses or deductions unless they are also allocated the related economic losses. By the same token, partners cannot be allocated taxable income or gain unless they are also allocated the related economic income.

Essentially, the substantial economic effect rules require that partner capital accounts be maintained and that they reflect the allocations of income, gain, loss, and deduction. (Capital accounts are simply a measure of each partner's equity in the partnership under whatever basis of accounting is used for that purpose.) Upon liquidation of the partnership, the partnership must pay partners or collect money from partners according to their respective positive or negative capital account balances.

In other words, a special allocation of taxable losses or income generally must result in a cost or benefit to the partner in terms of what the partner would receive if the partnership were liquidated. It is permissible for the partners receiving special allocations of tax losses to receive later *make up* allocations of income or gain.

However, if the partnership is unsuccessful, partners who received special allocations of losses will never realize the *makeup* allocations of income or gain. They will then pay for their special loss allocations by receiving less money when the partnership is wound up and all partner capital accounts are liquidated. In many cases, this will be a risk that is willingly accepted in return for the advantage of receiving tax benefits in the early years of the deal.

Example 7-7

The Cloud Concepts Limited Partnership is formed with two general partners, Phil and Bill, and 10 limited partners. Phil and Bill will contribute $10,101 each and supply the technical expertise. The limited partners will supply $2 million in startup capital.

Under the partnership agreement, the partnership will maintain capital accounts. Payments to partners or to the partnership upon liquidation will be based on positive or negative capital account balances, respectively. The capital account balances will be kept using *tax basis* accounting. Each partner's capital account will be charged with taxable losses and deductions allocated to him, and the partner's capital account will be credited with taxable income and gains allocated to him.

Taxable losses are expected in the first three years of operations. After that, the partnership is projected to begin generating positive taxable income.

Under the partnership agreement, the limited partners will be allocated 99 percent of cumulative taxable losses up to $2 million. Cumulative losses in excess of $2 million will be allocated 100 percent to the

general partners. Taxable income will be allocated 99 percent to the limited partners until the cumulative losses allocated to them have been offset and they have received a cumulative 10 percent annual return on their invested capital. Beyond that point, taxable income will be allocated 50/50 between the limited and general partners.

Essentially, the economic arrangement between the partners is a 50/50 deal after the limited partners have recovered their capital plus a 10 percent annual return. The tax allocation scheme described in this example will pass muster under the substantial economic effect rules, because if $2 million in losses are allocated to the limited partners and the partnership is liquidated for no value, the limited partners will receive nothing. (Their capital accounts will be *zeroed out* by the tax losses allocated to them.) The limited partners will have paid for their $2 million of deductions by losing their entire investment.

Alternatively, if the partnership is successful, the limited partners will receive current and liquidating distributions equal to their $2 million investment plus the cumulative amount of taxable income allocated to them.

The intent of the substantial economic effect rules is simply to enforce the concept that allocations of tax losses and income must correspond to allocations of the real economic losses and gains realized by the partnership. The tax allocation scheme in this example meets this standard, even though special tax allocations are involved.

Example 7-8

Use the same basic facts as in example 7-7, except that now the partnership agreement provides that the limited partners will be allocated 99 percent of all taxable losses throughout the life of the partnership, and the general partners will be allocated 99 percent of all taxable income throughout the life of the partnership. (Bill and Phil have huge net operating losses [NOLs] from their other activities, so they have no problem with this allocation.)

Distributions during the life of the partnership and upon liquidation will go 100 percent to the limited partners until they have recovered their $2 million investment plus a cumulative 10 percent annual return. Any distributions in excess of that amount will be allocated 50/50 between the limited and general partners.

As in the previous example, the economic arrangement between the partners is a 50/50 deal after the limited partners have recovered their capital plus a 10 percent annual return. However, this tax allocation scheme is not permissible under the substantial economic effect rules because the limited partners will be allocated taxable losses that will clearly have no effect on the distributions they are entitled to receive from the partnership. By the same token, the general partners will be allocated taxable income that will have no effect on the dollars they actually reap from the deal.

For example, if the partnership is very successful and is ultimately liquidated for $12 million, Bill and Phil will receive 50 percent of whatever is left after the limited partners receive their $2 million investment plus their 10 percent return. However, Bill and Phil will have been allocated 99 percent of the taxable income generated by the deal. This mismatch between the allocation of the economic gain (50/50) and the allocation of taxable income (99/1) is exactly the sort of thing the substantial economic effect rules are intended to shut down.

Activities Suitable for Limited Partnerships

Business and investment activities for which limited partnerships make sense include, but are not limited to, the following:

- Real estate investment and development activities when the partnership taxation rules allow investors to receive preferred returns, special allocations of tax losses, and additional basis from partnership-level debt
- Oil and gas exploration when the partnership taxation rules allow preferred returns and special allocations of deductions from intangible drilling costs
- Venture capital investments when the partnership rules allow pass-through taxation and the creation of ownership interests with varying rights to cash flow, liquidating distributions, and tax items
- Business start-ups expected to have tax losses in the initial years which can be passed through to the partners

Recommendation

Limited partnerships can be attractive in when all of the following conditions exist:

- There are at least two co-owners.
- Pass-through taxation is desired.
- LLC status is unavailable.
- Qualifying as an S corporation would be inconvenient, difficult, or impossible, or the entity could qualify as an S corporation, but the benefits of the partnership taxation rules are significant compared to the S corporation taxation rules, and co-owners who will be limited partners can live with the fact that they cannot become too actively involved in management of the venture without losing their limited liability protection.

Observation: Most advisers agree that multi-member LLCs, when available, are superior to limited partnerships. However, when pass-through taxation is desired, limited partnerships are the second best choice.

"Heavy" Sport Utilities, Pickups, and Vans Can Still Be Tax-Saving Machines

To understand how favorable the depreciation rules are for "heavy" sport utility vehicles (SUVs), pickups, and vans, you must first understand how *unfavorable* the rules are for lighter vehicles, such as cars and small pickups.

Skimpy Deductions for Cars, Light Trucks, and Light Vans

Per the IRC Section 280F(a) luxury auto depreciation limitations, relatively paltry federal income tax depreciation allowances apply to cars, light trucks, and light vans used for business. For such vehicles placed in service during 2011, box 7-1 provides the maximum depreciation deductions.

Box 7-1: 2011 Maximum Depreciation Vehicle Deductions

2011: New Cars With Bonus Depreciation	
Year 1	$11,060
Year 2	4,900
Year 3	2,950
Year 4 and thereafter until cost is recovered	1,775
2011: Used Cars Without Bonus Depreciation	
Year 1	$3,060
Year 2	4,900
Year 3	2,950
Year 4 and thereafter until cost is recovered	1,775
2011: New Light Trucks and Light Vans With Bonus Depreciation	
Year 1	$11,260
Year 2	5,200
Year 3	3,150
Year 4 and thereafter until cost is recovered	1,875
2011: Used Light Trucks and Light Vans Without Bonus Depreciation	
Year 1	$3,260
Year 2	5,200
Year 3	3,150
Year 4 and thereafter until cost is recovered	1,875

Key Point: When the vehicle is used less than 100 percent for business, the already-skimpy numbers shown in box 7-1 must be proportionately reduced to account for nonbusiness usage.

Bigger Deductions for Heavy Vehicles Used More Than 50 Percent for Business

The tax-saving strategy is to buy something outside the passenger auto classification. Specifically, a passenger vehicle is *not* considered to be a passenger auto if it has a *gross vehicle*

weight rating (GVWR), the manufacturer's maximum weight rating when loaded to capacity, greater than 6,000 pounds.[7]

Passenger vehicles that meet the preceding "heavy" definition are considered trucks for depreciation purposes, that is, five-year Modified Accelerated Cost Recovery System (MACRS) property, which is also eligible for the IRC Section 179 deduction.

New (not used) heavy vehicles are also eligible for first-year bonus depreciation in years when it is available, such as 2010–12. However, to be eligible for the IRC Section 179 deduction, first-year bonus depreciation, and accelerated MACRS depreciation, the heavy vehicle must be used more than 50 percent for business purposes.

First-Year Bonus Depreciation Allowed for 2010–12

Two separate pieces of tax legislation enacted in 2010 established a new set of first-year bonus depreciation rules for qualifying new (not used) assets placed in service in 2010–12. The rules as they pertain to business vehicles can be summarized in the following sections.

100 percent Bonus Depreciation for Heavy Vehicles Placed in Service between September 9, 2010, and December 31, 2011

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (better known as the Tax Relief Act of 2010) allows 100 percent first-year bonus depreciation for new (not used) heavy vehicles acquired and placed in service between September 9, 2010, and December 31, 2011.[8]

To be eligible for 100 percent first-year bonus depreciation, a heavy vehicle must pass both of the following tests:

- It must be purchased between September 9, 2010, and December 31, 2011.
- The original use must commence with the taxpayer by no later than December 31, 2011.

50 percent Bonus Depreciation for Heavy Vehicles Placed in Service in 2010

The Small Business Jobs Act of 2010 (enacted in September of 2010) allows 50 percent first-year bonus depreciation for new (not used) heavy vehicles placed in service in calendar year 2010. However as previously discussed, the Tax Relief Act of 2010 allows more-generous 100 percent first-year bonus depreciation for heavy vehicles placed in service between September 9, 2010, and December 31, 2011.

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[7] See IRC sec. 280F(d)(5)(A); Prop. Reg. 48.4001-1(b)(2)(ii) and (iii) via Prop. Reg. 145.4051-1(e)(3); and Ltr. Rul. 9520034.

[8] See IRC sec. 168(k).

Therefore, the combined effect of the two laws is to allow

1. 50 percent bonus depreciation for heavy vehicles placed in service between January 1, 2010, and September 8, 2010, and
2. 100 percent bonus depreciation for heavy vehicles placed in service during the remainder of 2010 and all of 2011.

To be eligible for 50 percent first-year bonus depreciation, a heavy vehicle must pass both of the following tests:

- It must be purchased by December 31, 2010.
- The original use must commence with the taxpayer by no later than December 31, 2011.

50 percent Bonus Depreciation for Heavy Vehicles Placed in Service in 2012

The Tax Relief Act of 2010also allows 50 percent first-year bonus depreciation for new (not used) heavy vehicles placed in service in calendar year 2012.

To be eligible for 50 percent first-year bonus depreciation, a heavy vehicle must pass both of the following tests:

- It must be purchased by December 31, 2012.
- The original use must commence with the taxpayer by December 31, 2012.

Impact of Bonus Depreciation on New Cars, Light Trucks, and Light Vans

For new (not used) passenger autos, light trucks, and light vans placed in service in calendar years 2010–12, the bonus depreciation breaks allowed by the Tax Relief Act of 2010 and the Small Business Jobs Act of 2010 increase the maximum first-year depreciation deductions under the luxury auto depreciation rules by $8,000, as follows:[9]

- For new cars used 100 percent for business, the maximum 2010 first-year depreciation deduction under the luxury auto rules is $11,060 ($8,000 + $3,060).
- For new cars used 100 percent for business, the maximum 2011 first-year depreciation deduction under the luxury auto rules is the same as 2010—$11,060 ($8,000 + $3,060).
- For new light trucks and light vans used 100 percent for business, the maximum 2010 first-year depreciation deduction is $11,160 ($8,000 + $3,160).
- For new light trucks and light vans used 100 percent for business, the maximum 2011 first-year depreciation deduction is $11,260 ($8,000 + $3,260).

Key Point: Revisit box 7-1, which reflects the $8,000 additional first-year depreciation.

[9] See IRC sec. 168(k)(2)(F).

Reduced IRC Section 179 Deduction for Heavy SUVs

Legislation enacted in 2004 placed a reduced $25,000 limit on IRC Section 179 deductions for heavy SUVs with GVWRs between 6,001 and 14,000 pounds.[10]

That is the bad news. The good news is that the $25,000 limitation has no impact on vehicles that are *not* considered to be SUVs. Per IRC Section 179(b)(6), "non-SUVs" include vehicles

- designed to seat more than nine passengers behind the driver's seat. For example, many shuttle vans and minibuses will qualify for this exception.
- equipped with a cargo area that is not readily accessible directly from the passenger compartment and that is at least 6 feet in interior length. The cargo area can be open or designed to be open but enclosed by a cap. For example, many pickups with full-size cargo beds will qualify for this exception. Some "quad cabs" and "extended cabs" with shorter cargo beds may not.
- with (1) an integral enclosure that fully encloses the driver's compartment and load carrying device, (2) no seating behind the driver's seat, and (3) no body section protruding more than 30 inches ahead of the leading edge of the windshield. For example, many delivery vans will qualify for this exception.

> **Key Point:** Vehicles with GVWRs greater than 6,000 pounds that meet the preceding descriptions are still eligible for the full IRC Section 179 deduction (that is, $500,000 for tax years beginning in 2010 and 2011).

Despite $25,000 Limitation, Depreciation Rules for Heavy SUVs Are Still Very Favorable

It is important to understand that heavy SUVs still have a huge depreciation advantage over vehicles classified as passenger autos because heavy SUVs used more than 50 percent for business still qualify for (1) the $25,000 IRC Section 179 deduction, (2) first-year bonus depreciation for new (not used) vehicles in years when bonus depreciation is allowed such as 2010–12, and (3) accelerated MACRS depreciation over 5 years for the balance of the vehicle's depreciable basis, after subtracting the IRC Section 179 deduction and any first-year bonus depreciation. In contrast, passenger autos fall under the skimpy, luxury auto depreciation limits listed earlier in this chapter.

Example 7-9

Phil buys a $40,000 used SUV in 2011 and uses it 100 percent in his Schedule C business. The maximum first-year depreciation deduction will generally be $28,000 ($25,000 IRC Section 179 deduction + $3,000 first-year MACRS deduction [20 percent × $15,000]). In contrast, the maximum first-year depreciation deduction for a $40,000 used passenger auto placed in service during the year and used 100 percent for

[10] IRC sec. 179(b)(6).

business is only $3,060— a big difference in favor of the SUV—despite the $25,000 limitation on the IRC Section 179 deduction. (See the following section for more information on the impact of bonus depreciation on a new vehicle.)

Bonus Depreciation Means Bigger First-Year Writeoffs for Heavy SUVs, Pickups, and Vans

As mentioned earlier in this chapter, the maximum IRC Section 179 deduction for heavy SUVs is $25,000. Congress keeps making noise about completely eliminating the IRC Section 179 deduction for heavy SUVs, but it has not happened yet. In fact, the 50 percent first-year bonus depreciation break combined with the $25,000 IRC Section 179 deduction makes heavy SUV's into really great tax-saving machines.

Example 7-9A

In July 2012, Reilly buys a new $65,000 SUV and uses it 80 percent in her single-member LLC software services business. The depreciable cost of the vehicle is $52,000 (0.8 × $65,000). On her 2011 Form 4562 (Depreciation and Amortization [Including Information on Listed Property]), she can claim a $25,000 IRC Section 179 deduction. Then, she can write off another $13,500 ([$52,000 – $25,000] × 0.5) under the 50 percent first-year bonus depreciation rule. Finally, she can generally write off another $2,700 ([$52,000 – $25,000 – $13,500] × 0.2) under the normal depreciation rules. When all is said and done, Reilly's first-year depreciation deductions add up to $41,200, which is a whopping 79 percent of the business portion of the SUV's cost.

Example 7-9B

In 2011, Theo buys a new $65,000 SUV and uses it 80 percent in his Schedule C business. The depreciable cost of the vehicle is $52,000 (0.8 × $65,000). On his 2011 Form 4562, Theo can deduct the entire $52,000, thanks to the 100 percent first-year bonus depreciation privilege. In this case, the IRC Section 179 deduction is a nonissue.

> **Key Point:** To qualify for both the IRC Section 179 deduction and first-year bonus depreciation privileges, an SUV must be used more than 50 percent for business, it must be new, and it must have a GVWR of more than 6,000 pounds. You can usually find the GVWR imprinted on the inside of the driver's door where the hinges meet the frame.

IRS Confirms That Heavy SUVs Escape Luxury Auto Depreciation Limits Whether Built on Truck or Car Chassis

As explained earlier in this chapter, the luxury auto depreciation limitations only apply to *passenger autos*.[11] When a vehicle used more than 50 percent for business is *not* classified as a passenger auto, it can be depreciated under the more generous MACRS rules for

[11] IRC sec. 280F(a)(1)(A).

transportation equipment which is considered to be 5-year property. In addition, *new* (not used) vehicles that fall outside the passenger auto classification are eligible for first-year bonus depreciation in years when it is available.[12] New vehicles that fall outside the passenger auto classification that are acquired and placed in service during calendar year 2011 qualify for 100 percent first-year bonus depreciation. Finally, new and used vehicles that fall outside the passenger auto classification are also eligible for the IRC Section 179 deduction. However, heavy SUVs are subject to a reduced IRC Section 179 allowance of only $25,000.

The tax-smart strategy is to buy vehicles that fall outside the passenger auto classification. A passenger vehicle with an enclosed body that is built on a truck or unibody chassis is *not* considered to be a passenger auto if it has a GVWR greater than 6,000 pounds. Revenue Procedure 2008-22 does not define trucks and vans as having to be built on a truck chassis, which was apparently intended to leave the tax-smart door open for heavy crossover SUVs with unibody construction.[13]

IRS Chief Counsel Advice 201138048 further clarifies that heavy SUVs are exempt from the passenger auto classification whether they are built on a truck chassis or an auto chassis. With this additional guidance, there is apparently no doubt that heavy SUVs built on any kind of chassis (for example, truck, unibody, car, and so on) are eligible for the aforementioned favorable depreciation treatment.

Do Not Forget IRC Section 179 Taxable Income Limitation

A taxpayer's annual IRC Section 179 deduction cannot exceed that year's aggregate net business taxable income from all sources (calculated *before* the IRC Section 179 writeoff). This rule prevents taxpayers from claiming big IRC Section 179 deductions in order to create tax losses that could then be carried back to earlier years. Of course, the net business taxable income limitation is much more likely to come into play with the current ultra-generous IRC Section 179 allowance (that is, $500,000 for tax years beginning in 2010 and 2011).

If your client conducts his or her business as a sole proprietorship, or as a single-member LLC treated as such for federal tax purposes, he or she can count any salary, wages, and tips that he or she may earn as an employee as additional net business taxable income. If the client is married and files jointly, he or she can also count his or her spouse's earnings from employment, as well as any net self-employment income he or she may earn from business activities in which he or she actively participates. These taxpayer-friendly loopholes reduce the odds that your client's business will be adversely affected by the taxable income limitation. Still, watch out for this rule.

> **Warning:** Be careful if your client runs his or her business as an S corporation, partnership, or multi-member LLC because the maximum IRC Section 179 deduction limitation (that is, $500,000 for tax years beginning in 2010 and 2011) and

[12] IRC sec. 168(k).

[13] See also IRC sec. 280F(d)(5)(A); Prop. Reg. 48.4001-1(b)(2)(ii) and (iii) via Prop. Reg. 145.4051-1(e)(3); and PLR 9520034.

> the net business income limitation apply at both the entity level and at the client's personal level. The rules are complicated, and planning may be required to get the most tax-saving mileage out of the IRC Section 179 deduction.

Do Not Forget IRC Section 179 Deduction Phase-Out Rule

The phase-out rule will not affect most small businesses, but tax advisers still need to know about it. A taxpayer's maximum IRC Section 179 deduction is reduced dollar for dollar (but not below zero) by the amount of *excess IRC Section 179 property* (assets that would otherwise qualify for the deduction) placed in service during the tax year. Recent legislation increased and extended the threshold for this unfavorable phase-out rule to $2 million for tax years beginning in 2010 and 2011.

Example 7-10

Your calendar-year client places $2,040,000 of IRC Section 179 property in service during 2011. The maximum IRC Section 179 deduction for the year is $460,000 ($500,000 "normal" maximum for tax years beginning in 2011 minus the $40,000 excess over the $2 million phase-out threshold for tax years beginning in 2011).

Less-Favorable IRC Section 179 Limits Are Scheduled for 2012

For tax years beginning in 2012, the maximum IRC Section 179 deduction is scheduled to fall to only $139,000 versus $500,000 for tax years beginning in 2010 and 2011. In addition, the deduction phase-out threshold is scheduled to fall to only $560,000 versus $2 million for tax years beginning in 2010 and 2011.

> **Observation**: Do not be surprised if these parameters are restored to the more-favorable levels that applied for 2010 and 2011.

Mind Stricter Rules for Corporate-Owned Vehicles

When a heavy SUV, pickup, or van is owned by your client's C or S corporation, the vehicle must be used more than 50 percent for actual corporate business activities in order to qualify for the IRC Section 179 deduction. Any personal use by an employee who is also a more-than-5-percent shareholder does not count as business use for this purpose, even when the personal-use value is reported as additional taxable compensation on the shareholder-employee's Form W-2. This is also true for corporate employees who are related to more-than-5-percent shareholders (such as the client's spouse and kids). When the more-than-50-percent business use test is failed, the corporation must depreciate the vehicle using the straight-line method, which means it will take 6 years to fully depreciate it. And the corporation can say goodbye to any IRC Section 179 deduction.[14]

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[14] See Treas. Reg. 1.179-1(d); IRC secs. 280F(b), 280F(d)(4)(A)(ii), and 280F(d)(6)(C)(i)(II).

Other Caveats

Heavy SUVs, pickups, and vans used for business are "listed property."[15] Therefore, they are covered by the strict business-use substantiation rules that apply to listed property. Also, remember that the IRC Section 179 deduction is unavailable for that part of the cost of a vehicle paid for with a trade-in transaction treated as an IRC Section 1031 like-kind exchange.[16]

No Income Limitation or Phase-Out Rule for First-Year Bonus Depreciation

Unlike the IRC Section 179 deduction, there is no income limitation on first-year bonus depreciation deductions. Therefore, they can create or increase an NOL that can be carried back to recover taxes paid for prior years. In addition, there is no phase-out rule. Therefore, when 100 percent first-year bonus depreciation is available, there is no reason to claim an IRC Section 179 deduction. Also, in some cases, it may pay to claim 50 percent first-year bonus deprecation for new vehicles instead of the IRC Section 179 deduction for new vehicles in years when 100 percent first-year bonus depreciation is unavailable.

Planning to Reduce Social Security and Medicare Taxes

For 2011 and 2012, the first $106,800 and $110,100, respectively, of net SE income is subject to SE tax at the maximum 13.3 percent rate, instead of the 15.3 percent maximum rate that normally applies. The 2 percent difference for these years is due to the 2 percent reduction in the Social Security tax rate. In other years, the normal 15.3 percent SE tax rate applies up to the annual Social Security tax ceiling.

SE income greater than the annual Social Security tax ceiling is still subject to the Medicare tax portion of the SE tax at a rate of 2.9 percent because the 12.4 percent Social Security tax portion of the SE tax cuts out above the Social Security tax ceiling. The 2.9 percent Medicare tax portion of the SE tax continues to hit SE income up to infinity. For shareholder-employee wages, the combined employer and employee Social Security and Medicare taxes add up to the same rates.

With the ever-increasing Social Security tax ceiling and no upper limit on the 2.9 percent Medicare tax, it is no wonder that small-business clients often ask for advice on how to reduce their Social Security and Medicare tax bills.

> **Key Point:** Due to virtually nonexistent inflation in 2008–10, the Social Security tax ceiling temporarily stagnated. However, it resumed its upward march in 2012 when it increased to $110,100. The government's fiscal 2011 year budget projects a

[15] IRC sec. 280F(d)(4).

[16] IRC sec. 179(d)(3) and Treas. Reg. 1.179-4(d).

Social Security tax ceiling of $113,100 for 2013; $117,600 for 2014; and $122,700 for 2015.

Employing Owner's Children in the Business

Some powerful tax incentives are available for clients operating sole proprietorships and husband-wife partnerships to hire their under-age-18 children as employees (in most cases, this will be on a part-time basis). The child's wages are exempt from Social Security and Medicare taxes, so there is no employer share of these taxes to pay and no withholding for the employee's share of these taxes. Similarly, there is no Federal Unemployment Tax Act (FUTA) tax. (Actually, the FUTA exemption extends to under-age-21 children.)[17]

The wages paid to the child are a business expense and accordingly reduce both the income tax and SE tax bills of the parent(s). The adjusted gross income (AGI) of the parent(s) is reduced, which generally can have only beneficial side effects. Finally, paying the child wages provides a way to transfer funds to the child in a tax-favored manner. In many cases, this is money that would have otherwise simply been given to the child or paid to someone outside the family to do the necessary work.

On the child's side of the equation, up to $5,950 of 2012 wage income can be sheltered by his or her standard deduction. An additional $5,000 of wage income can be sheltered by contributing to a deductible individual retirement account (IRA). Alternatively, the child could contribute up to $5,000 to a Roth IRA (no deduction).

The bottom line is that the parental employer saves on Social Security and Medicare taxes and gets an income tax and SE tax deduction, while the child is generally able to shelter most or all of the wage income from any form of federal tax.

Example 7-11

Barney operates a sole proprietorship direct marketing business. His marginal federal income tax rate is 35 percent, and his marginal SE tax rate is 2.9 percent. Over the summer, Barney pays his 2 children (ages 15 and 17) $2,000 each ($9 per hour) to select and install new computer hardware and software, teach him how to use it, update all his computerized records, assist in redoing his marketing materials, and so on.

The $4,000 wage deduction reduces Barney's income tax liability by $1,400 and his SE tax bill by $116 (ignoring the effects of the reduced deduction for 50 percent of his SE tax and the reduction in his AGI). There are no Social Security, Medicare, or FUTA taxes on the wages, and the children owe no federal income tax because their wage income is completely sheltered by their standard deductions.

Barney has succeeded in funneling $4,000 to his kids for the summer in a tax-effective manner, accomplishing a necessary technology upgrade for his business, and providing a good work experience for his offspring. Barney has also succeeded in putting off the cruel *tax day of reckoning* for his children, because they will not yet realize that federal payroll and income taxes ordinarily take a big bite out of one's wages.

Warning: Remember, wages must be reasonable in relation to the work performed. Therefore, this idea works best with teenagers who can be assigned meaningful duties, as in this example.

[17] See IRC secs. 3121(b)(3)(A), 3306(c)(5), and Circular E.

Example 7-12

Use same facts as in the previous example, except that now Barney operates his business as an S or C corporation.

In this case, the wages paid to the children are subject to Social Security, Medicare, and FUTA taxes under the same rules that apply to *regular* employees. This diminishes the appeal of the *hiring the kids* idea, but Barney still comes out ahead by doing so.

In the case of an S corporation, the wage expense, the company's share of the Social Security and Medicare taxes, and the FUTA tax reduce Barney's pass-through income and thus reduce his AGI and federal income tax. However, the money is kept in the family, and the children owe no income tax.

In the case of a C corporation, the wage expense, the company's share of the Social Security and Medicare taxes, and the FUTA tax are all deductible and, therefore, reduce the corporation's income tax bill.

The sexy term for these tax benefits is *family income-splitting*.

What About SE Tax for LLC Members?

In the case of a single-member LLC owned by an individual, the SE tax rules are applied by ignoring the existence of the LLC. (As explained earlier in this chapter, single-member LLCs are generally *invisible* for federal tax purposes.) Thus, the owner of the single-member LLC will compute his or her SE tax on Schedule SE in the same manner as a sole proprietor.

The SE tax situation for multi-member LLCs is much less clear. As stated earlier in this chapter, multi-member LLCs qualify to be treated as partnerships for federal tax purposes. The general rule is a partner includes his or her pass-through share of the partnership's income and loss from trade or business activities in his or her SE income.[18]

However, a *limited* partner includes in his or her SE income only IRC Section 707(c) guaranteed payments from the partnership. These payments are computed without regard to the level of partnership income and received for services rendered to the partnership in the capacity as a partner.[19] Such payments are commonly termed *partner salaries*. Assuming the partnership's trade or business activities generate taxable income, this is a favorable rule because it minimizes the limited partner's SE income and thus the SE tax.

Obviously, the SE tax rules were developed before LLCs treated as partnerships existed. The question becomes how do LLC members deal with the issue of SE tax, and specifically when can they escape SE tax on the theory that they should be considered limited partners because they are not personally liable for LLC debts?

In other words, if limited-partner status applies to LLC members for SE tax purposes, they can apparently avoid SE tax simply by *not* receiving any IRC Section 707(c) payments for services. Obviously, big dollars could be at stake, particularly for professional service LLCs.

In response to this *alarming* situation, the Treasury issued not one but two sets of proposed regulations (in 1994 and 1997) on the subject of SE tax for limited partners (read LLC members). Both generated controversy by in effect proposing that LLC members be required to

[18] IRC sec. 1402(a).

[19] See IRC sec. 1402(a)(13).

pay SE tax on certain LLC pass-through income in addition to any IRC Section 707(c) guaranteed payments for services.

Many commentators interpreted the proposed rules as imposing new taxes on LLC members, without the benefit of any supporting legislation. Congress agreed, and Section 935 of TRA Section 97 includes language prohibiting the release of any temporary or final regulations on the subject before July 1, 1998. The Treasury now concedes the proposed regulations have no validity, and as this book was written, there was no indication that further guidance will be forthcoming until Congress provides some direction.

Thus, one possible interpretation as this was written is that LLC members can completely avoid SE tax on their pass-through shares of LLC income by avoiding any IRC Section 707(c) guaranteed payments for services. However, the IRS may take the position that at least some of the cash distributions received by LLC members are in fact *disguised* IRC Section 707(c) guaranteed payments for services.

A less aggressive approach might be for LLC members to concede that they owe tax on a *reasonable* portion of their cash distributions by voluntarily treating such reasonable amounts as IRC Section 707(c) guaranteed payments for services. The members can then make a strong argument that no further SE tax is owed, because they have taken a very conservative approach to interpreting a very unclear law. In fact, this latter approach is essentially the same one used by S corporation shareholder-employees seeking to minimize federal employment taxes.

In the absence of clarification legislation, the author expects some litigation of this issue before long.

What the Tax Court Did Not STate

It is unlikely that many LLP partners have been making the argument that their income is exempt from the SE tax because the special SE tax rule for limited partners applies to them.

However, the argument that a member of a multi-member LLC treated as a partnership for tax purposes is exempt from the SE tax due to the special rule may not be so uncommon as explained earlier in this chapter. Although the *Renkemeyer, Campbell & Weaver, LLP,* decision does not apply to LLC members, it is not exactly encouraging to those who have been making the aforementioned argument. That said, the IRS is still claiming that LLC members must be treated as limited partners for purposes of determining material participation under the passive activity loss rules, as mentioned in the preceding section. Until the IRS stops making that claim, it is difficult to blame LLC members for claiming they are limited partners for SE tax purposes.

Beating the System by Incorporating

Many individuals operate their small businesses as S and C corporations and are technically employees of their corporations. For these shareholder-employees, minimizing Social Security and Medicare taxes, collectively referred to as federal employment taxes, is often a big goal.

S Corporations

Taxable income passed through by an S corporation (on Schedule K-1) to its shareholder-employees is not self-employment income for SE tax purposes.[20] Nor are cash distributions from the S corporation to the shareholder subject to the SE tax. Such cash payments are also exempt from federal employment taxes, except to the extent the payments represent employee compensation.

This situation has inevitably led to the tax planning idea of minimizing federal employment taxes by characterizing a relatively small portion of distributed S corporation cash flow as salary and a relatively large portion as *dividends* that can be received free of any federal employment taxes. In fact, some tax advisers view this tax planning opportunity as a good reason to operate as an S corporation rather than as an LLC, partnership, or sole proprietorship.

Of course, the IRS is aware of this maneuver and has on occasion attempted to recharacterize dividends as *disguised wages* subject to federal employment taxes. And the IRS has won in court several times, in cases when taxpayers took *silly* positions by understating shareholder–employee wages to a ridiculous extent.

Despite the outcome of these cases, the tax planning concept of keeping shareholder-employee wages *reasonably low* is still alive and well. How low can you go? As always, this is a matter of judgment, and documentation supporting the taxpayer's position is strongly recommended.[21]

Clearly, the stated salary need not be any more than what would be necessary to hire an outsider to perform the same job. It may be much easier to convince the IRS that a low salary is *reasonable* in the context of an S corporation than that a high salary is *reasonable* in the context of a C corporation attempting to avoid double taxation.

Example 7-13

Sport and Tessa are forming a new business as 50/50 co-owners. It can be operated as either an S corporation or as a partnership. The business is projected to earn annual taxable income of $200,000 before retirement plan contributions of $10,000 for each owner and $5,000 of medical insurance premiums for each.

Results With Partnership

If the business is operated as a partnership, each owner's SE income is $92,350 ($100,000 × 0.9235; their SE income is *not* reduced by the retirement plan contributions or medical insurance premiums). Thus, each owner's SE tax liability is $14,130 (15.3 percent of $92,350).

Results With S Corporation

If the business is operated as an S corporation and each owner is paid a *reasonable* salary of $50,000. The corporation will also make contributions of $10,000 for each owner to the company pension plan, and $5,000 will be paid for each owner's medical insurance premiums. The remaining corporate cash flow is distributed by paying federal-employment-tax-free dividends to each owner (Sport and Tessa have plenty of basis in their S corporation stock).

Federal employment taxes are due only on the stated salaries of $50,000. The company-paid medical insurance premiums are also considered taxable compensation to the shareholder-employees per Revenue Ruling 91-26, but the premiums are not subject to federal employment taxes as long as the

[20] Rev. Rul. 59-221.

[21] See Rev. Rul. 74-44 (1974-1 CB 287) for the IRS position.

requirements in IRS Announcement 92-16 are met. Thus, the federal employment tax liability for each owner is only $7,650 (15.3 percent of $50,000).

Compare the $7,650 amount to the $14,130 of SE tax due for each owner if the business is operated as a partnership. Operating as an S corporation saves over $6,000 in taxes for each owner.

Note: See the earlier explanation of the SE tax situation if Sport and Tessa operate their business as an LLC. They could minimize their SE tax by treating a *reasonably low* portion—say, $50,000—of the cash withdrawn from the LLC as IRC Section 707(c) guaranteed payments for services. Alternatively, they could apparently take the very aggressive position that no SE tax is due if they make sure they receive no guaranteed payment income whatsoever; ditto if they operate as an LLP in a state that provides LLC-like liability protection to LLP partners.

Example 7-14

McKenzie owns an existing sole proprietorship business. She is considering reducing her liability exposure by either contributing the business to a newly formed S corporation or to a newly formed single-member LLC (single-member LLCs are allowed in her state). The business is expected to earn annual taxable income of $100,000 before McKenzie's annual simplified employee pension (SEP) contribution of $10,000 and $5,000 of annual medical insurance premiums to cover McKenzie and her family.

Results With Single-Member LLC

If the business is operated as a single-member LLC, it will be treated as a sole proprietorship for federal tax purposes (in other words, nothing will change on McKenzie's Form 1040). McKenzie's SE income is $92,350 ($100,000 × 0.9235; her SE income is *not* reduced by the retirement plan contribution or her medical insurance premiums). Thus, her SE tax liability is $14,130 (15.3 percent of $92,350).

Results With S Corporation

If the business is operated as an S corporation, McKenzie can pay herself a *reasonable* salary of $50,000. (She is the only employee). The corporation will also make contributions of $10,000 to the company retirement plan set up for McKenzie's sole benefit, and $5,000 will be paid for her medical insurance premiums. The remaining corporate cash flow is distributed to her as a federal-employment-tax-free dividend. (McKenzie has plenty of basis in her S corporation stock).

Federal employment taxes are due only on the stated salary of $50,000. The company-paid medical insurance premiums are also considered taxable compensation to McKenzie per Revenue Ruling 91-26, but the premiums are not subject to federal employment taxes as long as the requirements in IRS Announcement 92-16 are met. Thus, the federal employment tax liability is only $7,650 (15.3 percent of $50,000).

Compare the $7,650 amount to the $14,130 of SE tax that McKenzie would owe if the business is operated as a single-member LLC or if she continues as a sole proprietor.

Better Long-Term Outlook for S Corporation Modest-Salary Strategy

Not too long ago, it looked like the strategy of paying modest salaries to S corporation shareholder–employees was destined for the dustbin of history. Most tax commentators were convinced that proposed legislation that would have outlawed the strategy would become law. The proposed legislation would have generally subjected S corporation net business income, whether paid out in salary or not, to federal employment taxes in essentially the same fashion as partnership net business income is subject to the SE tax under current law.

In other words, if the proposed legislation had passed, net business income allocable to each shareholder-employee up to the annual Social Security tax ceiling would have been subject to the 12.4 percent Social Security tax, and amounts higher than that ceiling would have been subject to the 2.9 percent Medicare tax. Thankfully, the proposed legislation got bogged down in Congress and ultimately died a quiet death. Then, the November 2010 midterm elections put the Republicans back in charge of the House, with a big majority. As long as the Republicans stay in control of the House, the author doubts there will be any anti-taxpayer changes in the federal employment tax rules for S corporations.

> **Key Point:** The window of opportunity is once again wide open for implementing the federal-employment-tax-reduction strategy of converting unincorporated small businesses into S corporations and then paying the shareholder-employees modest salaries.

Possible Negative Impact on Owner Retirement Contributions

When considering the S corporation modest salary strategy, keep in mind that paying modest salary amounts could have the negative side effect of reducing how much money can be contributed each year to your client's tax-favored retirement plan account, under a SEP plan or the like. However, you may be able to mitigate this concern by helping the client set up a 401(k) plan or a defined benefit pension plan that allows larger contributions.

C Corporations

Running a business as a C corporation can also save on taxes currently, but the client must be willing to live with the inherent risk of double-taxation problems down the road. As demonstrated by the preceding two examples, essentially all of a sole proprietor's, single-member LLC owner's, or partner's business income is subject to the SE tax.

In contrast, only the salary income of a C corporation shareholder-employee is generally subject to federal employment taxes. When shareholder-employee salaries must be kept low to maximize the corporation's cash flow to finance growth, the benefits are lower federal employment taxes and a lower current federal income tax bill because of the favorable graduated corporate rate structure.

Games You Can Plan With Health Benefits

Sole proprietors, single-member LLC owners, partners (including members of multi-member LLCs treated as partners), and more-than-2-percent S-corporation shareholder-employees usually can claim an above-the-line deduction for 100 percent of the cost of health insurance premiums to cover themselves, their spouses, and their children. This is thanks to the IRC Section 162(l) deduction privilege.[22]

[22] See IRC sec. 162(l) and Rev. Rul. 91-26.

The downside to the IRC Section 162(l) deduction is that it cannot be claimed on a self-employed taxpayer's Schedule C, E, or F which would reduce his or her self-employment tax liability.[23]

> **Key Point:** For 2010 only, the IRC Section 162(l) deduction can be subtracted in arriving at SE income on the taxpayer's Schedule SE, which amounts to the same thing as a Schedule C, E, or F deduction for SE tax purposes.

A Potential Solution for Sole Proprietors and Single-Member LLCs

What if the sole proprietor (or a single-member LLC owner treated as a sole proprietor) hires his or her spouse as an employee of the business and provides a medical expense reimbursement plan as an employee benefit pursuant to a written plan? The employee-spouse can then elect family coverage to cover the proprietor (single-member LLC owner) and the kids.

Actually, the IRS admits this scheme allows the proprietor (single-member LLC owner) to deduct 100 percent of the health insurance premiums and out-of-pocket medical expenses as a business expense on Schedule C and the employee-spouse to receive the benefit on a tax-free basis. Obviously, however, the overall compensation provided to the employee-spouse, including the insurance coverage, must be *reasonable*.[24]

Taking the writeoff on Schedule C creates a double tax break, because it reduces both income and SE taxes. This creates a self-insured medical expense reimbursement plan (even though part of the expense can actually be for health insurance premiums paid to a commercial insurer). As such, it must be set up under a written plan document to deliver the described tax benefits. The plan document should generally define reimbursable medical costs to include premiums for family medical and dental insurance coverage, insurance deductibles and co-payments, prescriptions, and any uninsured medical, dental, and vision care expenses. This type of plan is also often called a IRC Section 105 plan.[25]

For this deal to pass muster with the IRS, the employee-spouse might also be paid, for the sake of appearance, some cash wages during the year, as befits his or her status as a bona fide employee. However, such cash wages are not actually required. Cash wages are of course subject to Social Security and Medicare taxes, which amount to 13.3 percent on the first $106,800 for 2011 and 13.3 percent on the first $110,100 for 2012. But if the employee-spouse is only a part-time worker, this problem can be mitigated by making the cash wages a relatively small part of the total compensation package or by paying no cash wages. Most, or all, of the employee-spouse's compensation will be in the form of tax-free fringe benefit payments from the medical reimbursement plan.

Compensation in the form of an employer-provided medical expense reimbursement plan is not subject to Social Security and Medicare taxes or income tax, but the value of that

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[23] See IRC sec. 162(l)(4).

[24] See IRC secs. 162(a), 105(b), and 106(a); Rev. Rul. 71-588; and TAM 9409006.

[25] See IRC secs. 105 and 106.

benefit still counts in determining *reasonable compensation*.[26] Only the cash wage will be subject to federal employment taxes and income tax.

On the employer side of the equation, the sole proprietor (single-member LLC owner) deducts 100 percent of the insurance premium costs, the family's out-of-pocket medical bills, the cash wages, and the employer share of federal employment taxes on the cash wages. These deductions reduce the SE tax. (Of course, the cash wage deduction and income offset each other for income tax purposes.)

For years, the IRS had nothing bad to say about this arrangement. The silence ended in 1999, when the government released an Industry Specialization Program paper (ISP). The ISP stated that an employee-spouse cannot receive tax-free reimbursements under a self-insured medical expense reimbursement plan for expenses incurred before the plan was adopted. So according to the government, your client cannot set up the reimbursement plan in say December, effectively deduct all his or her medical insurance premiums and out-of-pocket medical expenses for the entire year and still have the reimbursements be tax-free to his or her employee-spouse.[27]

Is the IRS right about this *anti-retroactivity* rule? Common sense tells us yes, and the government has a court decision on its side too. The case involved a Nebraska farmer who hired his spouse and set up a medical reimbursement plan on December 16, 1993. The plan then reimbursed the employee-spouse for uninsured family medical expenses dating all the way back to the beginning of that year. The IRS stated that the retroactive reimbursements represented taxable income to the employee-spouse, so the maneuver failed to save on any taxes. The court agreed.[28]

Taking Care of the Details

This self-insured medical reimbursement plan idea involves several *do's and don'ts*. Clients should be given the following advice:

- Do set up the reimbursement plan early in the year, while most of the year's medical insurance premiums and out-of-pocket costs are still in the yet-to-be-incurred status. (This avoids the retroactive plan problem previously discussed.)
- Do draft a written plan document. It need not be complicated, but the plan must be set forth in writing.
- It is probably preferable to pay the employee-spouse at least a nominal cash wage and file the necessary payroll tax forms to account for Social Security and Medicare taxes plus any unemployment taxes and state taxes (although this is not strictly necessary). Also, do not forget to issue the employee-spouse a Form W-2 if a cash wage is paid.

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[26] See Reg. 1.162-7(a).

[27] See Industry Specialization Program UIL 105.06-05, *Coordinated Issue All Industries: Retroactive Adoption of an Accident and Health Plan*, dated March 29, 1999. The ISP cites Rev. Rul. 71-403 and American Family Mutual Insurance Co., 815 F. Supp. 1206, W.D. Wis. (1992), as authorities for its conclusions. On the same subject, the IRS later released ISP UIL No. 162.35-02 Settlement Guideline for Health Insurance Deductibility for Self-Employed Individuals (dated January 25, 2001).

[28] See *Walter W. Wollenburg, et ux.,* District Ct. Neb. (December 1, 1999).

- Do keep time reports to prove that the employee-spouse's compensation, including the reimbursements, was reasonable for the work performed.
- Do have the employee-spouse submit medical expenses for reimbursement at least twice a year (say on June 15 and December 15). Then issue reimbursement checks out of the business account to the employee-spouse. Indicate on the checks and in the check register that the payments are being made under the proprietorship's (single-member LLC's) medical reimbursement plan. The client's tax files should include copies of the receipts, and so on, to verify that the plan reimbursed only for legitimate family medical outlays.

> **Warning:** If the sole proprietorship (single-member LLC) has other employees, the self-insured medical reimbursement plan must be offered to them as well, on a nondiscriminatory basis.[29] Of course, if there are no other employees (or the only other employees are family members), this probably will not be a concern.

Sources for Plan Documents

At least one Web-based outfit will supply written *IRC Section 105* self-insured medical reimbursement plan documents and help clients with the paperwork. For information, go to www.netpayusa.com.

Partnerships and Multi-Member LLCs

Essentially the same rules explained in the previous section also apparently apply to partnerships and multi-member LLCs treated as partnerships. The partnership (LLC) can sponsor a written plan for the employee-spouses of partners (LLC members) as long as the spouses themselves are not also partners (members).

> **Warning:** If the partnership (multi-member LLC) has other employees, the self-insured medical reimbursement plan must be offered to them as well, on a nondiscriminatory basis.[30]

S Corporations

Unfortunately, the preceding strategy does not help more-than-2-percent shareholders of S corporations. IRC Section 1372(b), in conjunction with IRC Section 318, treats the spouses of more-than-2-percent shareholders as being more-than-2-percent shareholders themselves. Therefore, when the corporation provides health insurance coverage to employee-spouses of more-than-2-percent shareholders, only the 100 percent deduction allowed by IRC Section 162(l) and the itemized deduction allowed by IRC Section 213 (if any) are available (see Revenue Ruling 91-26).

[29] IRC sec. 105(h).

[30] IRC sec. 105(h).

The actual outlays by the S corporation for the insurance premiums are treated as additional compensation (not subject to federal employment taxes as long as the requirements in IRS Announcement 92-16 are met) paid to the shareholder. Similarly, there would be no tax advantage to reimbursing more-than-2-percent shareholders (or their spouses) for other out-of-pocket medical expenses.

What to Do When Spouses Are Active in the SE Activity

Advantages of Hiring the Business Owner's Spouse

Hiring the spouse of a sole proprietor (single-member LLC owner) can be a good idea to maximize deductions for health costs as explained earlier in this chapter. Hiring the spouse can also be a good idea when the spouse is already involved in the business, but his or her status has not been formalized. In such case, the IRS can mount an argument that the intended sole proprietorship (single-member LLC) is actually a husband–wife partnership, even though there is no written or oral partnership agreement.

IRS Publication 334, *Tax Guide for Small Business*, stipulates that a partnership return (Form 1065 [U.S. Return of Partnership Income]) should be filed when there is a husband–wife partnership. This can be extremely detrimental, because it results in two Schedules SE instead of just one, meaning there can potentially be 2 taxpayers subject to the 13.3 percent rate on the first $106,800 of 2011 and the first $110,100 of 2012 net SE income, instead of just 1.

Naturally, the IRS is likely to argue that the SE income should be split 50/50 between the spouses, because that will maximize the SE tax damage to the previously unsuspecting duo. The best advice is to head this potential problem off at the pass by formalizing the arrangement between the spouses before the IRS identifies the issue.

Treating the less-involved spouse as the other spouse's employee will often yield the best tax answer. The employer-spouse can pay some of the employee-spouse's *reasonably low* compensation in the form of health benefits coverage and the rest in the form of a modest cash wage. Then 100 percent of the health costs can be deducted, and only the cash wage will be subject to Social Security and Medicare taxes.

More on the Federal Tax Status of Unincorporated Husband–Wife Businesses

For example, your client operates his business as a sole proprietorship or single-member LLC (SMLLC) treated as such for federal tax purposes. The client's spouse has some involvement with the business from time to time. However, her participation has never been given any recognition for tax purposes.

Upon audit, the IRS could attempt to reclassify the client's sole proprietorship (SMLLC) as a husband–wife partnership (husband–wife LLC). The government could then argue that all business income and deductions must be split 50/50 between husband and wife (or 70/30, or another ratio).

The risk of the IRS making this argument was thought to be particularly acute in community property states, when under state law, a husband and wife are generally deemed to co-own all assets (including small business operations) on a 50/50 basis. If successful, the government's argument might not change the federal income tax results in any meaningful way. (The exception would be when tax elections required to be made at the husband–wife partnership [LLC] level were missed, because the client did not believe any such partnership [LLC] existed.)

However, the government's argument could have a disastrous effect on the client's SE tax results, as the following example illustrates.

Example 7-15

Stella's SMLLC business generates annual SE income substantially above the ceiling on the Social Security tax component of the SE tax ($110,100 for 2012). Stella has always treated her SMLLC as a sole proprietorship for federal tax purposes. Stella's husband, Steve, participates in the business from time to time. However, the couple's tax returns have never given any hint of Steve's involvement.

If the IRS audits Stella and Steve and argues that Stella's business is actually a husband–wife LLC that must be treated as a partnership for federal tax purposes, the IRS will reallocate a portion of the net business income from Stella to Steve. This may have no impact on the couple's federal income tax bill. However, all or part of the net SE income shifted from Stella to Steve will now be taxed at 13.3 percent instead of 2.9 percent. (This assumes Steve does not have enough wage income or unrelated SE income to hit the $110,100 Social Security tax ceiling for 2012.)

> **Key Point:** The husband–wife partnership (LLC) argument could cause a big chunk of SE income to be reallocated from one spouse to the other with a resulting multi-thousand dollar increase in the couple's joint SE tax liability.

Thankfully, Revenue Procedure 2002-69 explicitly provides that the IRS will *not* make the husband–wife partnership (LLC) argument against qualifying residents of community property states. Instead, the IRS will respect the taxpayer's treatment of an unincorporated business entity as either (1) a sole proprietorship (which would include an SMLLC treated as a sole proprietorship) or (2) a partnership (which would include a multi-member LLC treated as a partnership).

Put another way, when husband and wife treat their unincorporated business entity as a sole proprietorship for federal tax purposes, the IRS will not object, even when both spouses are active in the business activity. That is very good news! Alternatively, if husband and wife treat their unincorporated business as a husband–wife partnership for federal tax purposes and file partnership returns, the IRS will not object to that either.

It is very important to note that the relief offered by Revenue Procedure 2002-69 is limited to *qualified entities*. A business entity is a qualified entity when

- it is wholly owned by husband and wife as community property under the laws of a state, foreign country, or U.S. possession;
- no person *other* than the husband or wife (or both) would be considered an owner for federal tax purposes; and
- the entity is *not* treated as a corporation under the check-the-box entity classification rules of Treasury Regulation 301.7701-2.

Revenue Procedure 2002-69 also states: "A change in reporting position will be treated for federal tax purposes as a conversion of the entity." The following two examples illustrate the significance of this rule.

Example 7-16

Pursuant to Revenue Procedure 2002-69, Dave and Linda (married residents of a community property state) want to change the federal tax treatment of a qualified entity that has up until now been treated as a husband–wife partnership (that is, a husband–wife partnership or husband–wife LLC treated as such for federal tax purposes). Dave and Linda convert the qualified entity into a sole proprietorship for federal tax purposes (or SMLLC treated as such for federal tax purposes) by filing an initial Schedule C for the conversion year. Naturally, all the other federal tax consequences of converting and operating as a sole proprietorship must be considered as well. However, those consequences are generally benign, and there are usually no adverse or unexpected federal income tax consequences from the conversion itself.[31]

Example 7-17

Pursuant to Revenue Procedure 2002-69, Sandy (a married resident of a community property state) wants to change the federal tax treatment of a qualified entity that has up until now been treated as a sole proprietorship (that is, a sole proprietorship or SMLLC treated as such for federal tax purposes). Sandy can *convert* the qualified entity into a husband–wife partnership for federal tax purposes (or into a husband-wife LLC treated as such for federal tax purposes) by filing an initial Form 1065 for the year of conversion. Naturally, Sandy must also consider all the other federal tax consequences of converting and operating as a partnership. However, those consequences are generally benign, and there are usually no adverse or unexpected federal income tax consequences from the conversion itself.[32]

SE Tax Planning Opportunities in Community Property States

According to Revenue Procedure 2002-69, the rules explained previously apply "for federal tax purposes," which means they clearly apply for federal SE tax purposes. This opens up some nice SE tax planning strategies. Before getting into the strategies, however, this section will review the basic SE tax rules for residents of community property states.

[31] See IRC secs. 731, 732, 735(b), and 1223(1).

[32] See IRC secs. 721(a), 722, 723, and 1223(1).

Under state community property laws, business income (including from a partnership) is generally community income. As such, it must be split 50/50 between the spouses for federal income tax purposes. Of course, this rule makes no difference on a joint return. However, the 50/50 rule does not apply for SE tax purposes.

Instead, when *any* of the income from a *nonpartnership* business is considered community income, 100 percent of the gross income and deductions from said business must be allocated for SE tax purposes to the spouse who carries on the business.

In the case of business income from a *partnership*, the community property SE tax rule states that the spouse who is the partner must report 100 percent of his or her distributive share of partnership income for SE tax purposes, while the nonpartner spouse reports none.[33] When both spouses are partners in the partnership (including a husband–wife partnership), however, each spouse should report his or her distributive share of partnership income on his or her separate Schedule SE.

The following sections provide some SE tax planning strategies.

Convert Husband–Wife Partnership into Sole Proprietorship

Community property state residents who own qualified entities currently treated as husband–wife partnerships (or husband–wife LLCs treated as such for federal tax purposes) should consider converting them into sole proprietorships (or SMLLCs treated as such for federal tax purposes) when converting would produce meaningful SE tax savings. Consider the following example.

Example 7-18

Pursuant to Revenue Procedure 2002-69, Clark and Cindy (married residents of a community property state) decide to convert their 50/50 husband-wife partnership, which produces SE income of $200,000, into a sole proprietorship treated as belonging to Clark for federal tax purposes. Assume Clark and Cindy have no wage income and no other SE income from other sources. The conversion reduces the couple's 2012 SE tax bill by a whopping $9,350 ([$100,000 × 0.133 × 2] = $26,600 before the conversion compared to $17,250 after the conversion [$110,100 × 0.133] + [$89,900 × 0.029]).

The conversion is accomplished by liquidating the assets (if any) of Clark and Cindy's husband–wife partnership into the "new" post-conversion sole proprietorship considered to be owned by Clark. In most cases, the only federal income tax impact of the conversion will be ceasing to file Form 1065 and instead filing Schedule C for the "new" post-conversion sole proprietorship. However, the SE tax savings from the conversion can be substantial, as this example illustrates.

Variation

Use the same basic facts, except that now Clark and Cindy run the business as a 50/50 husband–wife LLC treated as a partnership for federal tax purposes. They convert the husband–wife LLC into an SMLLC treated as a sole proprietorship belonging to Clark for federal tax purposes. The tax results would be the same as the original example.

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[33] IRC sec. 1402(a)(5)(B).

Key Point: The conversion of a qualified entity for federal tax purposes will not necessarily require any action under state law and will not necessarily have any significance for general state law purposes (except to the extent the entity's federal tax treatment affects its treatment under state law). Therefore, implementing the conversion may involve nothing more than filing federal tax forms that properly reflect the conversion. In the preceding example, for instance, the liquidation of the husband–wife partnership into the "new" sole proprietorship may be a "deemed" transaction for federal tax purposes only and not an actual transaction for state law purposes. However, the state income tax implications (if any) of any conversion (whether actual or deemed) should always be evaluated before any action is taken.

Convert Sole Proprietorship into Husband–Wife Partnership

Community property state residents who own qualified entities currently treated as sole proprietorships (or SMLLCs treated as such for federal tax purposes) should consider converting them into husband–wife partnerships (or husband–wife LLCs treated as such for federal tax purposes) when converting would produce SE tax savings. Consider the following example.

Example 7-19

Frieda and Fritz are married residents of a community property state. Frieda's sole proprietorship generates $80,000 of SE income. Her husband Fritz earns a salary of $125,000 from an unrelated job. Pursuant to Revenue Procedure 2002-69, Frieda converts her sole proprietorship into a 50/50 husband–wife partnership for federal tax purposes. This action shifts $40,000 of SE income from Frieda to Fritz, which reduces the couple's 2012 SE tax bill by a cool $4,160 ($40,000 of SE income shifted to Fritz's Schedule SE, where it is taxed at only 2.9 percent; versus 13.3 percent if the same $40,000 is reported on Frieda's Schedule SE).

The conversion is accomplished by contributing the assets (if any) of the sole proprietorship to the "new" post-conversion husband–wife partnership. In most cases, the only federal income tax impact of the conversion will be ceasing to file Schedule C and instead filing Form 1065 for the "new" post-conversion husband–wife partnership. However, as illustrated by this example, the SE tax savings from a conversion can be substantial.

Variation

Use the same basic facts, except that now assume Frieda runs her business as an SMLLC treated as a sole proprietorship for federal tax purposes. She converts the SMLLC into a 50/50 husband–wife LLC for federal tax purposes. The tax results would be the same as the original example.

Key Point: Once again, the conversion of a qualified entity for federal tax purposes will not necessarily require any action under state law and will not necessarily have any significance for general state law purposes (except to the extent the entity's federal tax treatment affects its treatment under state law). Therefore, implementing the conversion may involve nothing more than filing federal tax forms that properly reflect the conversion. In the preceding example, for instance, the contribution of assets to create the "new" husband–wife partnership may be a "deemed" transaction for federal tax purposes only and not an actual transaction for state law purposes. However, the state income tax implications (if any) of any conversion (whether actual or deemed) should always be evaluated before any action is taken.

Federal Tax Status of Unincorporated Husband–Wife Businesses in Noncommunity Property States

As explained earlier in this chapter, the favorable guidance in Revenue Procedure 2002-69 is limited to unincorporated business entities (including sole proprietorships) owned by husband and wife as community property (with no other owners in the picture). What about unincorporated businesses in noncommunity property states? Several IRS publications attempt to create the *false* impression that involvement by both spouses in an unincorporated business activity *automatically* creates a partnership for federal tax purposes in noncommunity property states.[34] Of course, when husband–wife partnership status applies, Form 1065 must be filed along with a separate Schedule SE for each spouse. This can result in a much higher SE tax bill for the couple; ditto when husband-wife LLC status applies.

In most cases, the IRS will have a very tough time making the husband–wife partnership (LLC) argument. For proof, consider the following direct quote from Private Letter Ruling (PLR) 8742007. "Whether parties have formed a joint venture is a question of fact to be determined by reference to the same principles that govern the question of whether persons have formed a partnership which is to be accorded recognition for tax purposes. Therefore, while all circumstances are to be considered, the essential question is whether the parties intended to, and did, in fact, join together for the present conduct of an undertaking or enterprise. The following factors, none of which is conclusive, are evidence of this intent: (1) the agreement of the parties and their conduct in executing its terms; (2) the contributions, if any, that each party makes to the venture, (3) control over the income and capital of the venture and the right to make withdrawals; (4) whether the parties are co-proprietors who share in net profits and who have an obligation to share losses; and (5) whether the business was conducted in the joint names of the parties and was represented to be a partnership."[35] PLRs cannot be cited as authority. Nevertheless, the preceding analysis is technically correct and right on point, because it was written specifically to address the husband–wife partnership issue.

Of course, in many (if not most) client situations in which both spouses have some involvement in a purported sole proprietorship (or SMLLC treated as such for federal tax purposes), only one or two of the five factors listed in the PLR are present. In such circumstances, the IRS should *not* be successful in making the husband–wife partnership (LLC) argument. Regardless of the presence or absence of the other factors listed previously, the author believes the husband–wife partnership argument is especially weak when (1) the spouses have no discernible partnership agreement and (2) the business has not been represented as a partnership to third parties.

> **Key Point:** Pursuant to Revenue Procedure 2002-69, the IRS has now officially abandoned the husband–wife partnership (LLC) argument in community property states (in which spouses are generally 50/50 co-owners as a matter of state law),

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[34] See, for example, IRS Publication 225, *Farmer's Tax Guide*; IRS Publication 334, Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ); IRS Publication 533, Self-Employment Tax; and IRS Publication 541, Partnerships.

[35] See *Commissioner v. Tower*, 327 U.S. 280 (1946), 1946-1 C.B. 11; Commissioner v. Culbertson, 337 U.S. 733 (1949), 1949-2 C.B. 5; Luna v. Commissioner, 42 T.C. 1067 (1964); and Rev. Rul. 82-61, 1982-1 C.B. 13.

which undeniably makes the husband–wife partnership (LLC) argument just that much weaker in noncommunity property states (in which 50/50 co-ownership by spouses is definitely *not* preordained by state law).

Warning: Although it will often be possible to make a convincing argument that a husband–wife partnership does not exist, please do not get carried away. In the worst-case scenario, the IRS could attempt to assess the penalty for failure to file a partnership return.[36] For returns required for tax years beginning after 2009, the penalty amount is $195 per month for each spouse for up to 12 months, or until a partnership return is filed.[37] For a husband–wife business, the maximum penalty would be $4,680 ($195 × 2 × 12 = $4,680). Ouch! Therefore, taking a stand on this issue may not be worth the risk in some situations. That said, Revenue Procedure 84-35 provides a limited exemption from the failure-to-file penalty. The exemption is only available to domestic partnerships with 10 or fewer partners when all the partners have reported their proportionate shares of income and deductions on timely filed returns. When income or deductions are not allocated proportionately, the Revenue Procedure 84-35 exemption is unavailable.

Update on Simplified Compliance Rules for Unincorporated Husband-Wife Businesses in Noncommunity Property States

The general rule is that an unincorporated husband–wife business that is properly classified as a partnership for federal income tax purposes must comply with the partnership tax provisions, which include the requirement to file an annual Form 1065 partnership return and issue each spouse an annual Schedule K-1. This general rule applies equally to a husband–wife LLC that is properly classified as a partnership for federal income tax purposes.

Unfortunately, partnership tax status can create compliance headaches. The partnership tax rules are relatively complicated, and the required Forms 1065 and Schedules K-1 are notoriously difficult to prepare.

Thankfully, the Small Business and Work Opportunity Tax Act of 2007 included a simplification measure that allows certain unincorporated husband–wife businesses to elect out of partnership tax status for federal income tax purposes (state income tax rules may or may not be different). To be eligible for the election out, the spouses must file jointly, and the husband–wife business must be a qualified joint venture.

After electing out of partnership tax status, the spouses must separately report their respective shares of the venture's tax items on the appropriate IRS forms. For example, income and expenses from an eligible husband–wife business activity other than farming would generally be reported on separate Schedules C filed with the couple's joint Form 1040. Income

[36] Form 1065.

[37] See IRC Section 6698.

and expenses from an eligible husband–wife farming activity would be reported on separate Schedules F. Similarly, the spouses must separately report their respective shares of net SE income (if any) from the husband–wife operation on separate Schedules SE filed with the couple's joint Form 1040. Each spouse then receives credit for his or her share of the SE income for Social Security benefit eligibility purposes.[38]

> **Key Point:** Do not confuse this election-out rule with the previously discussed special rule for husband–wife LLCs in community property states (under Revenue Procedure 2002-69). The election-out rule relevant to this discussion is available to eligible unincorporated husband–wife businesses in all states, including noncommunity property states. Also, as explained subsequently, the IRS currently (and unofficially) claims that husband–wife LLCs are ineligible for the election-out rule.

How to Elect Out of Partnership Status

The election out is accomplished by the spouses separately reporting their respective shares of tax items from the qualified joint venture and separately reporting their shares of SE income (if any) in the fashion explained previously.

> **Key Point:** Electing out of partnership tax status will not change the married couple's joint federal income tax liability or their joint SE tax liability. However, electing out has the beneficial effect of eliminating the need to (1) comply with the complicated partnership tax rules and (2) prepare and file an annual Form 1065 and related Schedules K-1. In contrast, the ability to treat a husband–wife business as being solely owned by one spouse under Revenue Procedure 2002-69 can result in significant SE tax savings. Therefore, taxpayers should take advantage of the Revenue Procedure 2002-69 alternative when doing so would result in SE tax savings.

Definition of Qualified Joint Venture

According to the statutory language, a *qualified joint venture* (QJV) is an unincorporated business venture in which

1. the husband and wife are the only members of the venture.
2. both spouses materially participate in the venture's business.
3. both spouses elect out of partnership tax status in the manner explained previously.

The Joint Committee on Taxation's explanation of the election-out provision does not supply any additional information. However, one thing is quite clear: a husband–wife venture conducted by an entity that is classified as an S or C corporation for federal tax purposes *cannot* be a qualified joint venture. Corporations must always file separate federal returns on

[38] See IRC secs. 761(f) and 1402(a)(17).

Form 1120S (U.S. Income Tax Return for an S corporation) or Form 1120 (U.S. Income Tax Return for a C corporation).

The IRS has issued two clarifications on when a husband–wife business can meet the definition of a qualified joint venture. One clarification is good news for taxpayers, but the other is not.

IRS Admits Husband–Wife Rental Real Estate Business Can Be Qualified Joint Venture

The IRS now admits that an unincorporated husband–wife rental real estate business can meet the definition of a QJV and thus be eligible for the election out of partnership tax status.[39] Before 2008, it was unclear if the election out would be allowed for a rental real estate activity.

If the election out is made, net income from the rental real estate operation is not subject to SE tax. To make the election out for a rental real estate activity for 2011, the spouses should (1) report their respective shares of the QJV's income and expense items on separate Schedules E filed with the couple's joint Form 1040 and (2) check the QJV box on Line 2 of their Schedules E.

> **Note:** For 2010, the IRS directed the spouses to elect out by reporting their respective shares of the QJV's income and expense items on separate Schedules C filed with the couple's joint Form 1040 and checking the QJV box on line 1 of their Schedules C. The new drill for 2011 makes a lot more sense!

Unofficial IRS Guidance States Husband–Wife LLC Cannot Be Qualified Joint Venture

Now for the bad news. According to an IRS online article, a husband–wife joint venture that is operated as an LLC and that is currently treated as a husband–wife partnership for federal tax purposes does *not* meet the definition of a QJV. Therefore, according to the article, the election out of partnership tax status is not allowed. And, therefore, according to the article, a husband–wife LLC must comply with the burdensome partnership tax rules, with no relief in sight.

This IRS stand is also puzzling. Worse yet, it appears to be dead wrong. Neither the statutory language, nor the legislative history, nor common sense provide any support for the notion that a husband–wife LLC that is treated as a husband–wife partnership for federal tax purposes cannot be a QJV if the requirements explained earlier are met.

QJV status is clearly limited to unincorporated businesses, but an LLC is *not* an incorporated entity under applicable state law (LLCs are LLCs rather than corporations). In addition, an LLC that is classified as a partnership for federal tax purposes is obviously *not* an incorporated entity for those purposes either. Last, but not least, the IRS is out of bounds in using a

[39] See Chief Counsel Advice 200816030.

website article to take the controversial position that a husband–wife LLC cannot be a QJV. The IRS should only take such a position in authoritative guidance, such as a regulation or revenue ruling. An article on the IRS website has no technical authority and need not be followed by taxpayers unless it is supported by statutory language, legislative history, or some other form of legitimate official guidance.

For the reasons explained previously, some taxpayers might choose to ignore the unofficial guidance in the IRS website article and treat husband–wife LLCs as QJVs when the requirements explained earlier are met. However, taxpayers should be warned that the IRS has taken a contrary position in unofficial guidance—for what it is worth (which is not much).

> **Warning:** In the worst-case scenario, the IRS could attempt to assess the penalty for failure to file a partnership return.[40] For returns required for tax years beginning after 2009, the penalty amount is $195 per month for each spouse, for up to 12 months or until a partnership return is filed.[41] For a husband–wife business, the maximum penalty would be $4,680 ($195 × 2 × 12 = $4,680). Ouch! Therefore, going against the IRS on this issue may not be worth the risk—even though it is quite likely the IRS is wrong. That said, Revenue Procedure 84-35 provides a limited exemption from the failure-to-file penalty. The exemption is only available to domestic partnerships with 10 or fewer partners when all the partners have reported their proportionate shares of income and deductions on timely filed returns. When income or deductions are not allocated proportionately, the Revenue Procedure 84-35 exemption is unavailable.

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[40] Form 1065.

[41] See IRC sec. 6698.

8

Tax-Wise College Financing for Middle-Class Clients

Introduction

This chapter covers the key tax-savings opportunities in the college funding arena for middle-income clients. Chapter 9, "Tax-Smart College Financing Maneuvers for High-Income Clients," is oriented more toward planning tips for higher-income individuals.

Chapter 9 also includes some *last-minute* college financing tips that may work for middle-income taxpayers as well.

Education Tax Credits

Through 2012, two higher education tax credits are available to qualifying taxpayers:

- The American Opportunity Tax Credit (which replaces the old-law Hope Scholarship Credit)
- The Lifetime Learning Credit

These credits are claimed by completing Form 8863 (Education Credits [American Opportunity and. Lifetime Learning Credits]).

American Opportunity Credit

The American Recovery and Reinvestment Act of 2009 (better known as the stimulus act) replaced the familiar Hope Scholarship credit with the new American Opportunity credit.[1] The new credit provides up to $2,500, covering 100 percent of the first $2,000 of eligible post-secondary education expenses, plus 25 percent of the next $2,000 (assuming the adjusted gross income [AGI]-based phase-out rule explained later in this chapter does not apply).

[1] See Internal Revenue Code (IRC) sec. 25A.

Eligibility Rules

The credit is potentially available for a taxpayer, his or her spouse, and any person for whom the taxpayer can claim a dependent exemption deduction.

However, those who use married filing separate status are completely ineligible.

Eligible Students

Through 2012, a student's expenses are eligible for the American Opportunity credit as long as he or she has not already completed four years' worth of college work as of the beginning of the tax year in question. The credit can only be claimed for a maximum of four years for a particular student, but this is a big improvement over the old-lawHope Scholarship credit which only covered expenses for the first two years of college. Therefore, many individuals who would have been ineligible for the old-law Hope Scholarship credit are eligible for the American Opportunity credit.

As under the old-law Hope Scholarship credit rules, the American Opportunity credit rules provide that the determination of a student's year-of-study status is made as of the beginning of the tax year in question. For example, if the student had not yet achieved four years' worth of academic progress on January 1, 2012, tuition for schooling during all of 2012 can be counted as an eligible expense for purposes of the American Opportunity credit (assuming all the other rules are met for claiming the credit).

Treasury Regulation 1.25A-3(d) clarifies that a student's year-of-study status depends on his or her standing at the current institution. In other words, when a student has previously attended another school, only credits that are successfully transferred to the new school are counted in determining the student's year-of-study status at the new school. College academic credit that is awarded based solely on performance on proficiency exams does not count for purposes of determining if the student has completed four years' worth of academic work. So "testing out" of college classes or taking college classes before enrolling in a college degree program (for example, while in high school) will not undermine the student's eligibility for the credit. To sum up, only actual class credit earned while enrolled in a college degree program is counted in determining the student's year-of-study status for American Opportunity credit purposes.[2]

The American Opportunity credit is only allowed for a year during which the student carries, for at least one academic period beginning in that year, at least half of a full-time course load in a program that would ultimately result in an associate's degree, bachelor's degree, or some other recognized credential.[3] So, although an individual has to be a fairly serious student to claim the credit, he or she does not actually have to intend to *complete* a degree or credential program.

> **Key Point:** It is possible for one family to have several students who qualify for the American Opportunity credit in the same tax year. In such cases, a separate credit of up to $2,500 can be claimed for each student's college costs (assuming all the other American Opportunity requirements are met).

[2] See Treas. Reg. 1.25A-3(d).

[3] See Treas. Reg. 1.25A-3(d)(1).

Eligible Expenses

Eligible expenses for the American Opportunity credit include tuition, mandatory enrollment fees, and course materials, including books. However, optional fees for things such as student activities, athletics, and health insurance do not count. Room and board costs are also ineligible.

> **Key Point:** Your client can claim a 2012 credit for eligible expenses that are paid in 2012 for courses that begin in 2012 and expenses that are paid in 2012 for courses that begin in January through March 2013. Prepaying some expenses that are due early next year could lower your client's 2012 tax bill.

Eligible Institutions

A student must attend an *eligible institution*. Fortunately, virtually all accredited public, nonprofit, and for-profit postsecondary schools meet this definition, and many vocational schools do, too. The two main criteria are that (1) the school must offer programs that lead to an associate's degree, bachelor's degree, or some other recognized credential and (2) the school must qualify to participate in federal student aid programs. An eligible school will have a Federal School Code, which can be verified online at www.fafsa.gov.

Income Phase-Out Rule

The American Opportunity credit is phased out (reduced or completely eliminated) if modified adjusted gross income (MAGI) is too high. The phase-out range for unmarried individuals is between MAGI of $80,000 and $90,000, and the phase-out range for married joint filers is between MAGI of $160,000 and $180,000. These ranges are set by statute, so they apply through 2012, regardless of inflation. In this case, MAGI means AGI from the first line on page 2 of Form 1040 (U.S. Individual Income Tax Return) increased by income from outside the U.S. that is tax-exempt under IRC Section 911, 931, or 933.

> **Key Point:** Although the phase-out rule for the American Opportunity credit is still bad news for some individuals, the phase-out ranges are at much higher income levels than the ranges were for the old-lawHope Scholarship credit. Therefore, many taxpayers who would have been ineligible for the old-law Hope Scholarship credit will be eligible for the American Opportunity credit.

Credit Is Partially Refundable

The American Opportunity credit can be used to offset your client's entire federal income tax bill, including any alternative minimum tax (AMT). Any credit amount that is leftover after reducing the client's tax bill to 0 is refundable to the extent of 40 percent of the allowable credit amount (that is, the amount after any reduction under the AGI-based phase-out rule explained previously). The following example illustrates how the partial refundability concept works.

Example 8-1

Ellen's allowable American Opportunity credit is $2,500. The refundable part of the credit is $1,000 (0.40 × $2,500), and that amount is treated on her Form 1040 as a tax payment (as if she had the $1,000 withheld from her wages for federal income tax or paid it via estimated federal income tax payments). The remaining $1,500 (0.60 × $2,500) is a nonrefundable credit that does not do Ellen any good, unless she has a federal income tax liability.

If Ellen does not owe any federal income tax because of deductions, other credits, or both, the entire $1,000 refundable credit amount counts as a tax overpayment and is refunded to her in cash. In this case, the nonrefundable $1,500 part of the credit does not do Ellen any good, but the refundable credit deal gets her a $1,000 check from the government that she would not have otherwise received. Alternatively, Ellen can apply some or all of her $1,000 refundable credit toward her estimated tax payments for the following year.

If Ellen's federal income tax liability after deductions, other credits, or both is $1,900, the nonrefundable $1,500 part of the credit is used to reduce her tax bill to $400. Then the first $400 of the refundable credit reduces her tax bill to 0. Finally, the last $600 of the refundable credit is refunded to her in cash. In this case, the credit wipes out Ellen's entire tax bill, and the refundable credit deal gets her a $600 check from the federal government that she would not have otherwise received. Alternatively, Ellen can apply some or all of her $600 refundable credit toward her estimated tax payments for the following year.

If Ellen's federal income tax bill is $4,500, the $1,500 nonrefundable part of the credit reduces her tax bill to $3,000. Then the $1,000 refundable credit further reduces her tax bill to $2,000. In this case, the credit simply reduces Ellen's tax bill by $2,500, and that is the end of the story.

The preceding results are determined by filling out Form 8863 and transferring some numbers to the applicable lines on page 2 of Form 1040.

Warning: The 40 percent refundable credit privilege is not allowed to individuals who fall under the kiddie tax rules. In this case, the entire American Opportunity credit is treated as a nonrefundable credit. (As you know, the kiddie tax rules can potentially cause part of an under-age-24 individual's unearned income to be taxed at the parent's higher marginal rates.)

Year-end Planning

Creditable expenses must actually be paid in the tax year in question for courses in academic periods beginning in that year, or for courses in academic periods beginning in the first three months of the following tax year.[4]

Because academic years span two calendar years, it may sometimes be necessary to prepay some expenses in order to collect the maximum American Opportunity credit when expenses are relatively modest (for example, when the student attends a community college).

Example 8-2

If a college is on a quarter system, it may be beneficial to prepay tuition for the winter quarter (beginning in January 2013) before the end of 2012, in order to ensure that at least $4,000 of eligible expenses are paid in 2012. That way, the full $2,500 American Opportunity credit can be claimed for 2012 (assuming no problem with the income phase-out rule).

[4] Treas. Reg. 1.25A-5(e)(1) and (2).

Lifetime Learning Credit

The rules for the familiar Lifetime Learning credit are unchanged from previous years.[5] The credit equals 20 percent of up to $10,000 of eligible education expenses, for a maximum annual credit of $2,000 (assuming the income phase-out rule explained later in this chapter does not apply). Unlike the American Opportunity credit, there is no limit on the number of years the Lifetime Learning credit can be claimed, nor is there any course load requirement.

Therefore, the Lifetime Learning credit can be used to help offset costs for undergraduate study that continues for more than four years, undergraduate years when a student carries a light course load, graduate school courses, courses to improve job skills or maintain professional certifications, or courses taken for just about any other reason.

> **Key Point:** A self-employed client will often be better off claiming a Schedule C deduction for work-related education expenses that would also qualify for the Lifetime Learning credit. The tax benefit from the credit is only 20 percent. In contrast, claiming a Schedule C deduction will usually save on taxes at a 25 percent or greater marginal rate while also reducing the self-employment tax hit at a marginal rate of either 15.3 percent (13.3 percent for 2011 and 2012) or 2.9 percent.

Eligibility Rules

Individuals are ineligible for the Lifetime Learning credit if they are married and do not file a joint return with their spouse. Also, the maximum amount of annual expenses for which the credit can be claimed is limited to $10,000, regardless of how many students are in the family, and a client cannot claim both the American Opportunity credit and the Lifetime Learning credit for expenses paid for the same student for the same year. However, clients *can* potentially claim the American Opportunity credit for one or more students in the family while also claiming the Lifetime Learning credit for expenses paid for one or more *different* students in the family.

Eligible expenses for the Lifetime Learning credit include tuition and mandatory enrollment fees. Course supplies and materials (including books) are eligible expenses only if they are *required* to be purchased directly from the school itself. Other expenses, including optional fees and room and board, are off limits.

Additionally, the school must be an *eligible institution* using the same definition as for the American Opportunity credit.

> **Key Point:** Your client can claim a 2012 credit for eligible expenses that are paid in 2012 for courses that begin in 2012 and expenses that are paid in 2012 for courses that begin in January through March of 2013. Prepaying some expenses that are due early next year could lower your client's 2012 tax bill.

[5] See IRC sec. 25A.

Income Phase-Out Rule

Like the American Opportunity credit, the Lifetime Learning credit is phased out if MAGI is too high. However, the phase-out ranges for the Lifetime Learning credit are at much lower income levels:

- For 2012, the phase-out range for unmarried individuals is between MAGI of $52,000 and $62,000.
- The phase-out range for married joint filers is between MAGI of $104,000 and $124,000.

In this case, MAGI means AGI from the first line on page 2 of Form 1040 increased by income from outside the U.S. that is tax-exempt under IRC Section 911, 931, or 933.

Credit Is Not Refundable

There is no partial refundability deal for the Lifetime Learning credit. For 2010 and 2011, the credit can be used to reduce a client's regular federal income tax bill, as well as any AMT liability. (The author hopes that Congress will extend the AMT courtesy for 2012.)

Rules Applying to Both Credits

If a student is claimed as a dependent of the parent, only his or her parent can take the American Opportunity or Lifetime Learning credit, even if the student pays the qualifying expenses. This is because the expenses are deemed paid by the parent.[6]

Qualifying expenses are reduced by any IRC Section 117 scholarships, veteran and military education assistance payments, and most tax-free payments for educational expenses or attributable to enrollment.[7]

The same tuition expense dollars cannot be used to qualify for one of the credits and also to qualify for the interest income exclusion for U.S. Savings Bonds redeemed to pay for college expenses. In other words, tuition expenses used to take advantage of the savings bond break must be reduced by tuition expenses taken into account in computing either the American Opportunity or Lifetime Learning credit.[8]

If a *third party* (someone other than a taxpayer, taxpayer's spouse, or a claimed dependent) pays education costs for the taxpayer, spouse, or a claimed dependent, the expenses are treated as paid by the student for purposes of the American Opportunity and Lifetime Learning credits. (However, there could be gift-tax consequences for the third party.) If the expenses relate to a dependent, they are in turn considered paid by the taxpayer on whose return the dependent is claimed (usually the parent).[9]

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[6] IRC sec. 25A(g)(3).

[7] IRC sec. 25A(g)(2).

[8] IRC sec. 135(d)(2).

[9] See Treas. Reg. 1.25A-5(a) and (b).

Example 8-3

Monique is a dependent of her parents, Phil and Chelsea. Hillary, Monique's wealthy grandmother, offers to pay $20,000 of tuition for Monique's first year at Rice University.

Because Hillary is a *third party*, Monique is treated as paying the $20,000 for American Opportunity or Lifetime Learning credit purposes.

If Phil and Chelsea claim Monique as a dependent, they are in turn treated as paying the $20,000 for American Opportunity or Lifetime Learning credit purposes.

However, if Phil and Chelsea forgo claiming the dependency exemption deduction for Monique, she can claim a credit for herself.

Beating the System

The biggest problems with both the American Opportunity and Lifetime Learning credits are the AGI-based phase-out rules which make many clients ineligible. The planning solution is to arrange for the client's child to take the credit, assuming the child has enough taxable income to benefit from doing so.

Treasury Regulation 1.25A-1(f) states that the child can take the credit for his or her education expenses as long as the parent does not claim him or her as a dependent for IRC Section 151 dependent exemption deduction purposes. It does not matter if the parent pays some or all of the child's education expenses.

The tax benefit to the family group gained from giving the credit to the child must be weighed against the tax detriment to the parents from giving up the dependency exemption deduction ($3,800 for 2012).

The fact that the parents forgo the exemption does not entitle the child to the deduction. If the student is a dependent (parents pay over half the support), he or she cannot claim a personal exemption.[10] However, if the parents are affected by the AGI-based phase-out rule for dependent exemption deductions, the tax detriment may be considerably less than the tax benefit from the credit. Through 2012, the personal exemption deduction phase-out rule is gone, but it will be back with a vengeance in 2013 if the so-called Bush tax cuts are allowed to expire.

Deduction for Higher Education Tuition and Fees

The American Opportunity and Lifetime Learning tax credits are not always available for family education expenses. For example, the student in question might not meet the eligibility rules (a distinct possibility with the American Opportunity credit) or the client's income might be too high (a distinct possibility with the Lifetime Learning credit, less so with the American Opportunity credit). Do not give up hope. There is another important break that might work for your client.

[10] IRC sec. 151(d)(2).

IRC Section 222 allows taxpayers to claim a limited above-the-line deduction for eligible higher education tuition and fees. Depending on your client's income, the maximum writeoff is either $4,000 or $2,000.

> **Warning:** The IRC Section 222 deduction expired at the end of 2011, but it will likely be reinstated for 2012 with the preexisting rules. Those rules are explained in the following section.

Eligibility Rules

Taxpayers cannot claim the IRC Section 222 deduction for tuition and fees if they claim either the American Opportunity credit or the Lifetime Learning credit for the same student's expenses for the same year. No double dipping! However, your client is allowed to claim the IRC Section 222 deduction for one child's expenses (or for the client's own expenses) while claiming credits for expenses incurred by other students in the family.

Taxpayers are completely ineligible for the deduction if they are married and file a separate return. Also, IRS rules state that taxpayers must already have a high school diploma or GED in order to claim the deduction.

Eligible expenses include tuition, mandatory enrollment fees, and course materials, including books and supplies. However, the IRS states that taxpayers can only deduct course materials if they are required to purchase them directly from the school. Optional fees for things such as student activities and insurance are not deductible. Room and board costs are off limits, too.

The expenses must be to attend an *eligible institution*. Virtually all accredited public, nonprofit, and for-profit postsecondary schools pass this test, as well as some vocational schools. The two main criteria are that (1) the school must offer programs that lead to an associate's degree, bachelor's degree, or some other recognized credential and (2) the school must qualify to participate in federal student aid programs. An eligible school will have a Federal School Code, which can be verified online at www.fafsa.gov.

Although taxpayers can only claim the IRC Section 222 deduction for expenses to attend an institution which offers some sort of postsecondary degree or credential, they do not actually have to pursue a degree or credential to claim the deduction. For example, clients can claim it for career-related courses and professional certification courses offered by a university, community college, or any other eligible institution.

Taxpayers can claim a 2011IRC Section 222 deduction for eligible expenses that are paid in 2011 for courses that begin in 2011, or for eligible expenses paid in 2011 for courses that begin in January through March 2012. Pre-paying some expenses that are due early in 2012 could lower your client's 2011 tax bill.

Maximum Deduction and Income Cut-Off Rule

If the client is unmarried with MAGI of $65,000 or less, the IRC Section 222 deduction equals the lesser of (1) $4,000 or (2) 100 percent of eligible expenses. The same is true for a married joint-filing couple with MAGI of $130,000 or less (for a married couple with

income in this range, $4,000 is the maximum deduction even when both spouses have eligible expenses).

If the client is unmarried with MAGI between $65,001 and $80,000, the maximum deduction is reduced to the lesser of (1) $2,000 or (2) 100 percent of eligible expenses. The same is true for a married joint-filing couple with MAGI between $130,001 and $160,000 (for a married couple with income in this range, $2,000 is the maximum deduction even when both spouses have eligible expenses).

If MAGI exceeds the $80,000 or $160,000 ceiling (whichever applies), the client gets no deduction at all.

In this case, MAGI means AGI from the first line on page 2 of Form 1040 increased by any income from outside the U.S. that is tax-exempt under IRC Section 911, 931, or 933, and increased by any IRC Section 199 domestic production activities deduction (these adjustments will not apply to most individuals).Client Could Claim Either the Deduction or a Credit

As mentioned earlier in this chapter, your client cannot claim both the IRC Section 222 deduction and the American Opportunity credit or the Lifetime Learning Credit for expenses paid for the same student for the same year. They must pick Door No. 1 or Door No. 2.

If the client qualifies for the rather generous American Opportunity credit, it will deliver more tax savings than the IRC Section 222 deduction. Therefore, they should claim the credit.

In the more common scenario in which the client qualifies for the Lifetime Learning credit but not the American Opportunity credit, it can sometimes be a close call in figuring whether the Lifetime Learning credit is more valuable than the IRC Section 222 deduction, or vice versa. The tradeoff gets complicated because it depends on the amount of eligible expenses, the client's marginal tax rate, and whether the credit phase-out rule applies. The only sure way to find out which break is best is to fill out Form 8863 to calculate the Lifetime Learning credit and Form 8917 (Tuition and Fees Deduction) to calculate the IRC Section 222 deduction. Then, complete the rest of the return to see which break lowers the client's tax bill the most.

Deduction for Student Loan Interest

IRC Section 221 provides an *above–the-line* deduction for interest on education loans. However, the writeoff is limited to a maximum annual amount of $2,500.

To qualify, the debt must be incurred within a reasonable time before or after eligible higher education expenses are incurred. Eligible expenses are defined as tuition, fees, room and board, and related expenses, such as books and supplies for the taxpayer, spouse, or any dependent of the taxpayer to attend an eligible educational institution. Note that dependent status for a person is determined under IRC Section 152 rules, without regard to certain

restrictions on the taxpayer's ability to claim a dependent exemption deduction for that person.[11]

The deduction is only allowed for expenses attributable to a year during which the student carries, for at least one academic period beginning in that year, at least half of a full-time course load in a program that would ultimately result in an associate's degree, bachelor's degree, or some other recognized credential.[12]

For 2012, the deduction is phased out for unmarried taxpayers between MAGI of $60,000 and $75,000. For joint filers, the phase-out range is between MAGI of $125,000 and $155,000. For purposes of IRC Section 221, MAGI means *regular* AGI after adding back the deductions under IRC Sections 199 and 222 and the income exclusions under IRC Sections 911, 931, and 933.

Married individuals who file separate returns can forget about this break, regardless of their income level. They are completely ineligible.

Obviously, when the parents won't qualify for the interest deduction because their income is t*oo high*, the next best thing is to arrange for their child—the student—to get the deduction by taking out a student loan in his or her own name. However, no deduction is allowed to children in years they are dependents on their parents' returns, even when the child is on the hook for the loan and pays the interest. This issue can be finessed by scheduling the start date for loan repayments after graduation. By then, the child should be self-supporting and no longer a dependent on Mom and Dad's return.

The planning suggestion when the parents' high MAGI level precludes student loan interest writeoffs, is to take the loan out in the student's name and defer payments until after graduation. This action may salvage the deduction, although the student rather than the parents will be the beneficiary of the deduction.

If an education loan is refinanced, the refinanced loan will also qualify as such.[13] Per IRC Section 221(f)(1), student loan interest is not deductible if it is deductible under another code section. For example, if a deduction is allowed under the IRC Section 163(h) home equity loan rule, the interest cannot also be deducted as student loan interest under IRC Section 221.

Coverdell Education Savings Accounts

Coverdell Education Savings Accounts (CESAs) can be set up to pay the education expenses of a child (the account beneficiary), pursuant to IRC Section 530.

Contributions—up to $2,000 per year per beneficiary—are nondeductible, but earnings accumulate tax-free. Tax-free withdrawals can then be taken to pay for the beneficiary's post-secondary tuition, fees, books, supplies, and room and board.

[11] See IRC sec. 221(d) and the 2011 Form 1040 (U.S. Individual Income Tax Return) instructions for line 33 where the deduction is claimed.

[12] See IRC sec. 221(d)(3), IRC sec. 25A(b)(3), and Treas. Reg. 1.25A-3(d)(1).

[13] IRC sec. 221(d).

The ability to contribute is phased out between MAGI of $95,000 and $110,000 for single filers and $190,000 and $220,000 for married joint filers. For this purpose, MAGI means *regular AGI* increased by amounts excluded under IRC Sections 911, 931, and 933. If the parents' MAGI is too high to allow a contribution, any other person can contribute to the account, for example, the child's grandparents could contribute the $2,000 annual maximum. If the client has several children (or grandchildren), he or she can contribute up to $2,000 annually to separate CESAs set up for each.

Taxpayers can also take tax-free CESA payouts to cover elementary and secondary school (K-12) costs. Under this new privilege, eligible expenses include tuition and fees to attend private and religious schools, plus room and board, uniform, and transportation costs. Taxpayers can also withdraw CESA money tax-free to pay out-of-pocket costs to attend public K-12 schools. Eligible expenses include books and supplies; academic tutoring; computers, peripheral equipment, and software; and even Internet access charges.

Starting CESA contributions at an early date is really important if your client wants to benefit from this break. Taxpayers have until April 15 of the following year to make their annual CESA contributions. A tax-free CESA withdrawal cannot be used to cover the same expenses for which the American Opportunity credit or Lifetime Learning credit is claimed or for the same expenses for which the IRC Section 222 tuition and fees deduction is claimed.[14]

Tax-Free Employer Reimbursements for Higher Education Costs

Under an IRC Section 127 educational assistance program, an employer can pay or reimburse for up to $5,250 of annual education expenses for each participating employee. This benefit is tax-free to the employee, and the employer can deduct the cost. Both college undergraduate and graduate tuition costs are eligible; room and board expenses are not.

> **Key Point:** The IRC Section 127 break is only available to employees of the sponsoring employer. An employee's spouse and children are ineligible.[15] The good news, however, is that there are no AGI-based limits on this tax-saving deal, nor is there any requirement that the education be in any way related to the employee's job.

Penalty-Free Individual Retirement Account Withdrawals

To the extent of qualified higher education expenses paid during the same year that early withdrawals (before age 59½) are taken from an account owner's traditional or Roth individual retirement account (IRA), the early withdrawals are free of the 10 percent premature

[14] See IRC sec. 530(d)(2)(C) and (D) and IRC sec. 222(c)(2)(B).

[15] IRC sec. 127(c)(1).

withdrawal penalty tax that might otherwise apply to such early withdrawals. Qualified higher education expenses are defined in the same way as for tax-free withdrawals from IRC Section 529 plans. The qualified expenses must be for the education of (1) the account owner or the account owner's spouse or (2) a child, stepchild, or adopted child of the account owner or the account owner's spouse. This exception to the 10 percent penalty tax cannot be used for expenses that are allocable to certain tax-free educational benefits such as scholarships.[16]

Key Point: The qualified higher education expenses must be paid in the same year during which the early IRA withdrawal is received.[17]

Although early withdrawals from traditional IRAs can qualify for the 10 percent penalty tax exception explained previously, any earnings included in such withdrawals must still be included in the account owner's gross income. In other words, penalty-free does not equate to income-tax-free.

Tax-Free Interest From U.S. Savings Bonds

Under IRC Section 135, a taxpayer can exclude all or part of her accrued interest income from Series EE and Series I U.S. Savings Bonds redeemed (cashed in) to pay for certain education expenses of the taxpayer, spouse, and dependents for whom dependent deductions are allowed. However, there are serious restrictions as explained in the following sections.

Qualifying Savings Bonds

The savings bond must be issued after 1989 in the name of an individual, and that person must have attained age 24 before the bond issue date (any person can be named as the beneficiary in the event of the taxpayer's death).

The interest exclusion is unavailable to married taxpayers who file separate returns.[18]

Warning: When purchasing savings bonds, consider the following:

- Savings bonds should not be purchased in the names of children if the intent is to take advantage of this income exclusion by later cashing in the bonds to pay for college, because that would violate the age requirement.
- Bonds should be purchased in the parent's name.
- Any bonds issued in the parent's name from when he or she was a kid cannot be used to take advantage of the interest exclusion, because that would violate both the age requirement and the issued-after-1989 rule.

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[16] See IRC sec. 72(t)(2)(E) and (t)(7).

[17] See *Linda L. Lodder-Beckert,* TC Memo 2005-162 (2005).

[18] IRC sec. 135(d)(3).

Qualifying Expenses

Qualified education expenses are limited to tuition and fees net of any assistance from veteran's benefits, tax-free scholarships, employer-provided payments, or any other tax-free educational benefits.

> **Key Point:** Qualified expenses do not include any expenses for room and board or books. Also excluded are expenses for courses or programs involving sports, games, or hobbies unless the course or program is part of a degree program.

The educational expenses must be incurred at an eligible educational institution, which includes most colleges, junior colleges, degree nursing schools, and many vocational schools.

The same tuition expense dollars cannot be used to qualify for the American Opportunity credit or the Lifetime Learning credit or the IRC Section 222 tuition and fees deduction and also for the tax-free savings bonds interest income break. In other words, expenses used to take advantage of the savings bond break must be reduced by expenses taken into account in claiming these other breaks.[19]

Taxpayers can also redeem their qualified savings bonds tax-free (provided the other IRC Section 135 rules are met) if the proceeds are contributed to an IRC Section 529 qualified state tuition program. For purposes of determining the later taxability of education benefits paid for by the qualified state tuition program account, the investment in the tuition program contract will not include the amount of excluded interest income from the redeemed savings bonds.[20]

Also, qualified savings bonds can be redeemed tax-free (provided all the other IRC Section 135 rules are met) if the proceeds are contributed to a CESA set up for the taxpayer's dependent child.[21] However, the $2,000-per-year CESA contribution limit would still apply.

Computing the Amount of Excluded Interest

If the qualified higher education expenses for the year the qualified savings bond is redeemed equal or exceed the redemption proceeds, all of the accrued interest income is excluded, provided the taxpayer does not run afoul of the AGI-based phase-out rule covered later in this chapter.

If the proceeds exceed qualifying expenses, only a fraction of the interest income can be excluded. The fraction is calculated by dividing the qualifying expenses for the year by the bond redemption proceeds for that year.

Example 8-4

Marnie redeems qualified savings bonds for $10,000 ($8,000 original cost plus $2,000 accrued interest). Her daughter's qualifying education expenses for the year are at least $10,000.

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[19] See IRC sec. 135(d)(2) and IRC sec. 222(c)(2)(B).

[20] See IRC sec. 135(c)(2)(C).

[21] IRC sec. 135(c)(2)(C).

Marnie can potentially exclude the entire $2,000 of accrued interest (pending the application of the AGI-based phase-out rules). But, if her daughter's qualifying expenses are only $6,000, Marnie can potentially exclude only 60 percent of the interest, or $1,200 ($6,000 qualifying expenses divided by $10,000 bond redemption proceeds times the $2,000 of interest).

Phase-Out Rules for Higher-Income Taxpayers

The savings bond interest exclusion is phased out for relatively high-income taxpayers; in other words, those most likely to be able to afford to buy savings bonds to fund higher education expenses in the first place.

Congress giveth, and Congress taketh away.

For qualified savings bonds redeemed in 2012, the inflation-adjusted phase-out ranges are between MAGI levels in the following chart.

	Phase-Out Begins	Phase-Out Complete
Married filing joint returns	$109,250	$139,250
Single or head of household	72,850	87,850

In this case, MAGI means *regular* AGI before any excluded interest from qualified savings bonds under these rules and before income exclusions for employer-provided adoption assistance benefits, foreign income, income from Puerto Rico, and income from U.S. possessions and before the deductions for domestic producers, college loan interest, and qualified tuition and fee expenses (under IRC Sections 137, 911, 931, 933, 199, 221, and 222, respectively).If the taxpayer's MAGI exceeds the beginning phase-out level but is underneath the complete phase-out level, a fraction is computed to determine how much of the interest exclusion is phased out. The phase-out fraction is the amount of MAGI in excess of the phase-out beginning level divided by $30,000 for joint filers or $15,000 for single and head of household filers.

Example 8-5

Sean is a married joint filer with 2012 MAGI of $120,900. Sean's phase-out fraction is 0.3883 ([$120,900 – 109,250] / $30,000).

Sean had $3,000 of interest income from qualified savings bonds redeemed during 2012. During the year Sean paid $11,000 in qualifying higher education expenses for his son, Bucko. The full $3,000 of interest is *potentially* excludable because Sean's qualifying education expenses exceeded the qualified savings bond redemption proceeds.

However, because Sean's income is too high, he loses 38.83 percent of the exclusion, or $1,165. In other words, after the AGI-based phase-out rule, Sean can exclude only $1,835 ($3,000 – $1,165) of the interest income. That's still much better than nothing, but not nearly as good as advertised.

Key Point: MAGI includes the taxpayer's interest income from any qualified savings bond redemptions, even if all or part of the interest turns out to be excludable.

Example 8-6

Fred and Wilma are young married parents who anticipate that their income will increase fairly rapidly over the years. The couple is interested in the concept of using tax-free U.S. Savings Bonds to partly finance the college costs for their daughter BonBon. (They like the idea of investing in savings bonds because their investment philosophy is extremely conservative.)

Although Fred and Wilma's income is currently well below the AGI-based phase-out start point, they anticipate they will be over the cutoff point for tax-free savings bond redemptions by the time BonBon enters college.

The couple should consider redeeming qualified savings bonds in a year before they are affected by the phase-out rules and contributing the proceeds to an IRC Section 529 qualified state tuition program account set up for BonBon's benefit. The contribution counts as a qualified education expense and the savings bond interest income exclusion will be available, because Fred and Wilma's income is not yet high enough to be adversely affected by the phase-out rules.

Electing the Accrual Method for U.S. Savings Bonds

Another college financing strategy involves the use of Series EE savings bonds. When issued in the name of the college-bound child, there are no AGI-based phase-out rules or other tax-law restrictions to worry about. This strategy applies in the following situations:

- The 2012 standard deduction amount for a dependent child with only unearned income is $950.
- If the child is subject to the kiddie tax, it only applies to unearned income above $1,900. If the child is age 24 or older as of December 31, 2012, the kiddie tax cannot possibly apply.
- The general rule for accrued interest income on U.S. Savings Bonds is that it goes untaxed until the year the bonds are redeemed.

However, an election can be made to report the accrued income on an annual basis.[22] This election should be considered if the child has no other unearned income and the annual accrued interest from the savings bonds will always be below the standard deduction amount ($950 for 2012). Making the election in this situation means the interest goes completely untaxed.

Even if the annual accrued interest exceeds the standard deduction amount, the excess will be taxed at only 10 percent or 15 percent unless the kiddie tax applies.

Example 8-7

Willie, age 3, owns several U.S. Savings Bonds that mature in future years. Willie has no other income. The annual accrued interest income from the bonds will average $700. (Because of compounding, the annual interest income accrual will gradually rise.)

[22] IRC sec. 454 and Treas. Reg. §1.454-1(a).

If Willie's parents file a return on his behalf and make the election to report the accrued savings bond interest income annually, the annual amounts will be free of any federal income taxes because they will be sheltered by Willie's standard deduction (the 2012 standard deduction for dependents with no earned income is $950).

When Willie eventually redeems the bonds (to pay for college or for any other reason), there will be only the final year's worth of accrued interest to worry about. Again, that amount will be sheltered by Willie's standard deduction in that year.

A return should be filed in the election year to document the election. Returns need not be filed in later years as long as Willie's income remains below the filing requirement level.

How to Make the Election

The following statement should be filed with the return for the election year:

> Taxpayer hereby elects pursuant to IRC Section 454 to currently recognize as income the annual increment in the redemption price of U.S. Savings Bonds described in Treasury Regulation 1.454-1(a)(1). This election applies to such savings bonds owned on January 1 of [*enter year*] and such savings bonds acquired after that date.

9

Tax-Smart College Financing Maneuvers for High-Income Clients

Introduction

As explained in chapter 8, "Tax-Wise College Financing for Middle-Class Clients," higher-income clients are affected by phase-out rules that reduce or eliminate the two higher education tax credits, the deduction for tuition and fees, and the student loan interest deduction. The same is true for the privilege of contributing to Coverdell Education Saving Accounts (CESAs) and the tax-free U.S. Savings Bond redemption break. The good news is that there are other tax-efficient ways for high-income folks to finance college expenses. These other ways are the focus of this chapter.

Splitting Investment Income With the Kids

Back in the good old days, it was often possible to save on taxes by investing in a college-bound child's name rather than in the parent's name to take advantage of the child's lower federal income tax rates (that is, the rates for a single unmarried person). This strategy is called splitting income with the child.

The concept of splitting income is simple. The client makes gifts to the college-bound child. Under the $13,000 annual gift tax exclusion, a married couple can jointly give up to $26,000 per year to the child without paying any federal gift tax, without diminishing the $5.12 million unified federal gift and estate tax exemption allowed to each spouse (for 2012).[1] Investments are then made in the child's name, and the resulting income and gains are split off from the parents' return and hopefully taxed at the child's lower rates. The college fund then compounds that much quicker, because the after-tax rate of return is that much higher.

When parents start a college savings program well ahead of time, they can allocate a relatively large percentage of the college fund to equities (stocks and equity mutual funds)

[1] See Internal Revenue Code (IRC) sec. 2503(b).

in earlier years. This allows the parents to take advantage of the much higher returns these investments are expected to earn. (Of course, actual returns depend on market conditions.) As the first year of college draws closer, it is best to allocate an increasing percentage of the college fund to fixed-income assets (CDs, Treasuries, and high-quality corporate bonds). As the need for funds becomes imminent, risk in the college account's portfolio should be reduced and liquidity increased. So far, so good, but watch out for the kiddie tax rules, which were made much worse by recent law changes.

> **Key Point:** Thanks to the 2008–9 stock market meltdown, many parents still have substantial capital loss carryovers that can be used to shelter capital gains accumulated in taxable parental college savings accounts and up to $3,000 of ordinary income from taxable parental college savings accounts. Therefore, saving for college in the parent's taxable brokerage firm account may now be a very tax-smart option. As a bonus, this option avoids having to deal with the kiddie tax rules.

The Kiddie Tax Rules

Under the kiddie tax rules, part of a dependent child's unearned income (typically from investments) can be taxed at the parent's marginal federal income tax rate, which can be as high as 35 percent, or 15 percent for long-term capital gains and qualified dividends (through 2012), instead of at the child's lower rates (that is, the rates that would otherwise apply to an unmarried taxpayer with a modest amount of income), which can be as low as 10 percent, or 0 percent for long-term gains and dividends (through 2012). The good news is the kiddie tax rules only apply to a dependent child's unearned income above the annual threshold, which is $1,900 for 2012. For post-2012 years, the threshold may be higher due to inflation adjustments.[2]

Example 9-1

Your client's 10-year-old son owns some investment assets though a custodial account set up in the child's name (managed by the client). The assets produce $5,000 of investment income in 2012. The first $950 is sheltered from any federal income tax by the child's 2012 standard deduction. The next $950 is taxed at only 10 percent (or 0 percent for long-term gains and dividends). The next $3,100 ($5,000 – $950 – $950) is taxed at your client's marginal rate, which could be as high as 35 percent (or 15 percent for long-term gains and dividends).

Child's Age Is the Key Factor

Until a few years ago, the kiddie tax only applied to years when the child was under age 14 at year-end. If the child was age 14 or older at year-end, the kiddie tax did not apply to the child for that year or any subsequent year.

Under the current rules, the kiddie tax can potentially come into play until the year during which the child turns 24. Put another way, the kiddie tax will never apply to an individual

[2] See IRC sec. 1(g).

who is age 24 at year-end or older. For an individual who is age 19–23 at year-end, the kiddie tax only applies if he or she is a student for that year. More specifically, the kiddie tax is an issue only when all 4 of the following requirements are met for the year in question:

1. One or both of the child's parents are alive at year-end and in a higher marginal federal income tax bracket than the child.
2. The child does not file a joint return for the year.
3. The child's unearned income for the year exceeds the threshold for that year, and the child has positive taxable income after subtracting any applicable deductions, such as the standard deduction. The unearned income threshold for 2012 is $1,900 (in future years, it may be adjusted periodically for inflation). If the unearned income threshold is not exceeded, the kiddie tax does not apply for that year. If the threshold is exceeded, only unearned income in excess of the threshold is hit with the kiddie tax.
4. The child falls under one of the age rules due to his or her age at year-end and other applicable factors. Unfortunately, the age rules are complicated. In fact, there are actually three separate age rules as follows:[3]

    a. *Age rule 1 (under age 18).* If the child has not reached 18 at year-end (in other words, he or she is 17 or younger on December 31), the kiddie tax will apply if the other 3 requirements are also met for the year. It makes no difference whether or not the child is claimed as a dependent on her parent's return (or on anyone else's return).
    b. *Age rule 2 (age 18.* If the child is 18 at year-end, and he or she does not have *earned* income (as defined by Internal Revenue Code [IRC] Section 911[d][2]) that exceeds half of his or her support (support is generally determined the same as for dependency exemption purposes), the kiddie tax will apply if the other 3 requirements are also met. It makes no difference whether or not the child is claimed as a dependent on his parent's return (or on anyone else's return). His or her support does not include amounts received as scholarships.
    c. *Age rule 3 (age 19–23 and student.* If the child is age 19–23 at year-end and (1) is a student and (2) does not have *earned* income that exceeds half of his or her support, the kiddie tax will apply if the other 3 requirements are also met. It makes no difference whether or not the child is claimed as a dependent on his or her parents' return (or on anyone else's return). A child is considered to be a student if he or she attends school full-time for at least 5 months during the year. His or her support does not include amounts received as scholarships.

    Key Point: Under the current kiddie tax rules, properly determining the amount of a child's support and the amount of a child's earned income are important issues, due to Age Rules 2 and 3.

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[3] IRC sec. 1(g)(2)(A).

Example 9-2

Joseph will be age 17 on December 31, 2012. He falls under Age Rule 1. For 2012, he will be subject to the kiddie tax if the other 3 requirements are also met. It makes no difference whether or not he is claimed as a dependent on his parent's return (or on anyone else's return).

Example 9-3

Susan will be age 18 on December 31, 2012. She does not have earned income that exceeds half of her support for the year. She falls under Age Rule 2. For 2012, she will be subject to the kiddie tax if all of the other 3 requirements are also met. It makes no difference whether or not she is claimed as a dependent on her parent's return (or on anyone else's return). Susan's support does not include any amounts received as scholarships.

Variation

Susan has earned income that exceeds half of her support for 2012. She is exempt from the kiddie tax for the year because none of the age rules apply to her for the year.

Example 9-4

Baxter will be age 19 on December 31, 2012. He does not have earned income that exceeds half of his support for the year, and he is a student for the year. He falls under Age Rule 3. For 2012, he will be subject to the kiddie tax if the other 3 requirements are also met. It makes no difference whether or not he is claimed as a dependent on his parent's return (or on anyone else's return). Baxter's support does not include any amounts received as scholarships.

Variation

Baxter is not a student for 2012. In this scenario, he is exempt from the kiddie tax because none of the age rules apply to him for the year. However, 2013–16 could be different stories if he is a student for any of those years.

Example 9-5

Steve will be age 21 on December 31, 2012, and he graduates from college in May 2012. He is subject to the kiddie tax for 2012 under Age Rule 3 (because he is a full-time student for the first 5 months of the year and has very little earned income for the year). Assuming he is done with school, however, none of the age rules will apply to him for 2013 and beyond, and he will not be subject to the kiddie tax in any of those years.

Variation

Steve gets a job in June 2012. As a result, he has earned income in excess of half of his support for the year. In this variation, Age Rule 3 does not apply, so Steve is exempt from the kiddie tax for 2012.

Example 9-6

Emily will be age 24 on December 31, 2012. For 2012 and all subsequent years, she is exempt from the kiddie tax because none of the age rules can possibly apply to her. Hooray! She is finally out of the woods for good.

Kiddie Tax Avoidance Strategies Can Save the Day

When the kiddie tax bites, it will at least partially defeat the tax-saving purpose behind family income-splitting. And that is exactly what Congress had in mind. However, do not give the kiddie tax rules more respect than they deserve, because the tax can be minimized or maybe even completely avoided with careful planning.

> **Key Point:** The kiddie tax applies only to unearned income which basically means investment income and capital gains from stocks, mutual funds, bonds, CDs, and the like. Earned income from jobs or self-employment is always exempt from the kiddie tax.

Finesse the Age Rules

One key thing to remember is that the kiddie tax does not apply to any year when the child does not fall under 1 of the 3 age rules. For any such year, the child is kiddie-tax exempt and is therefore treated like any other unmarried taxpayer (assuming he or she is, in fact, unmarried). To illustrate what this means, consider that a Kiddie-Tax-exempt child can have up to $35,350 of taxable income in 2012 (earned, unearned, or both) and never pay more than 10 percent or 15 percent (or 0 percent on long-term capital gains and qualified dividends) to the U.S. Treasury.

> **Key Point:** If the child is not a student for years after reaching age 18, Age Rule 3 will not apply and the child will be Kiddie-Tax-exempt.

> **Key Point:** After the child graduates from college, Age Rule 3 (for students age 19–23) will cease to apply (possibly starting with the year of graduation) unless the child goes back to school.

> **Key Point:** Age Rules 2 and 3 (for students age 18–23) will not apply if the child has *earned* income that exceeds half of his or her support for the year. Funneling enough earned income to the child can make kiddie tax problems vanish. For example, if the child's parent runs a business that can hire the child, the resulting extra earned income could make the child kiddie-tax exempt.

Example 9-7

Your client's 20-year-old child is a college student. He earns money over the summer doing yard work, cleaning pools, and taking care of pets for folks on vacation. Your client also employs his son part-time in the client's sole proprietorship business, because he is a computer genius (at least compared to your client). The client pays the child $15 per hour for his technical skills. Is any of this child's earned income affected by the kiddie tax? No. The kiddie tax does not hit earned income, so it will be taxed at the child's low rates.

Additionally, the child can shelter all or part of his earned income with his standard deduction. For 2012, the standard deduction shelter is $5,950. It may increase in future years thanks to inflation adjustments.

If it is necessary to gain even more shelter, the child can make a deductible contribution to a traditional individual retirement account (IRA) based on his earned income.

If the child's earned income is enough to exceed half of his support, the kiddie tax will not apply, which means all the child's unearned income will also be taxed at his low rates. Problem solved! This child is kiddie-tax exempt.

The child may also be entitled to a personal exemption deduction and an American Opportunity or Lifetime Learning tax credit.

Invest Carefully and Avoid Triggering Substantial Unearned Income in Kiddie Tax Years

The truth is, a child can actually have a good deal of money in his or her own name and still avoid the kiddie tax with advance planning.

For example, your client's child can invest in growth stocks. There will not be any significant unearned income until shares are sold, because these companies pay little or nothing in dividends. Following a buy and hold strategy with such stocks until a year during which the child is kiddie-tax exempt would mean all or a good chunk of the eventual capital gains will probably be taxed at a very low rate, maybe even 0 percent. Using a buy and hold strategy with tax-efficient mutual funds should also minimize or completely avoid the kiddie tax.

Also, a child can have a substantial amount invested in Series EE U.S. Savings Bonds and never pay a dime of kiddie tax because the interest is tax-deferred until the bonds are actually cashed in. If the cash-in date is deferred until a year when the child is kiddie-tax exempt, there will not be any kiddie tax on the accumulated interest.

Finally, investing for college using an IRC Section 529 plan account or a CESA can avoid kiddie tax problems, because qualified distributions are federal-income-tax-free and, thus, exempt from the kiddie tax even when the account is owned by a child.

> **Key Point:** If necessary, a student can attempt to postpone triggering unearned income in excess of the annual threshold until after graduating from college. Until then, the student can try to make ends meet with college loans, work-study income, other sources of financial aid, and loans from the parent. That way, the child can avoid Age Rule 3 and thereby avoid the kiddie tax.

> **Key Point:** Similarly, a parent can transfer appreciated assets to a child after he or she graduates from college. Until then, the student can get by with loans and other sources of cash. That way, the child can avoid Age Rule 3 and thereby avoid the kiddie tax when he or she sells the appreciated assets to pay off his or her loans.

Exploit Unearned Income Threshold

Last but not least, remember that the kiddie tax only applies when a child has unearned income for the year in excess of the applicable threshold. For 2012, the threshold is $1,900. In future years, the threshold may be adjusted periodically for inflation.

Example 9-8

In 2012, Zelda is a 20-year-old college student. Her parents provide more than half of her support. For that year, she has no earned income, but she has $1,900 of unearned income from a custodial account funded with gifts from her parents.

Under these facts, the kiddie tax does not apply to Zelda in 2012, because her unearned income does not exceed the threshold. In this scenario, the first $950 of her investment income will be sheltered by her $950 standard deduction. The next $950 will be taxed at a 10 percent marginal federal rate. Her federal income tax bill will be only $95 (0.10 × $950). As you can see, the effective tax rate is only 5 percent ($95/$1,900).

If Zelda has $1,901 of investment income, only the last dollar will be taxed at her parent's higher marginal rate. The 5 percent effective rate would still apply to the first $1,900 of ordinary unearned income. This is not bad!

Calculating the Kiddie Tax

The kiddie tax is calculated by filling out Form 8615 (Tax for Certain Children Who Have Investment Income of More Than $1,900). The completed Form 8615 is then attached to the child's Form 1040 (U.S. Individual Income Tax Return). In effect, the kiddie tax calculation piles the child's unearned income in excess of $1,900 on top of the parent's income. The tax on that excess unearned income is then figured at the parent's higher marginal rates. The additional tax that results from the excess unearned income being taxed at the parent's higher marginal rates is then reported on the child's Form 1040.

Saving for College Using Parent's Taxable Account

Your client can always choose to save and invest for a child's college expenses by using the client's own taxable brokerage firm account. The maximum federal income tax rate on long-term capital gains and qualified dividends is only 15 percent (through 2012). If the client still holds appreciated shares in the college account when the child heads off to school, the client should consider giving some to the child. The child can then sell the shares, pay the resulting capital gains tax at a reduced rate, and use the after-tax dollars to pay college costs. If the client's college account holds shares that have declined below cost, the client can sell them, claim the resulting capital losses on his or her return, and make a cash gift directly to the child's college, to the child, or a combination of both, to cover college costs.

> **Key Point:** Due to the 2008 stock market meltdown, many parents still substantial capital loss carryovers that can be used to shelter capital gains accumulated in taxable parental college savings accounts and up to $3,000 of ordinary income accumulated in taxable parental college savings accounts. Therefore, saving for college in a parent's taxable brokerage firm account may now be a very tax-smart option. As a bonus, this option avoids having to deal with the kiddie tax rules.

Saving for College Using Child's Roth IRA

If the client's child has earned income from jobs or self-employment, he or she can make annual nondeductible Roth IRA contributions. For 2012, the maximum contribution is the lesser of (*a*) $5,000 or (*b*) earned income. (For post-2012 years, the $5,000 contribution ceiling may be adjusted periodically for inflation.) After reaching college age, the child can withdraw up to the cumulative amount of his or her annual Roth contributions without owing any federal income tax or penalties. After that, he or she can withdraw Roth IRA earnings to pay for college costs without being hit with the 10 percent premature withdrawal penalty tax. However, withdrawn earnings will be subject to federal income tax at the child's presumably low rates. Of course, it is best to leave as much money as possible in the Roth IRA. That way, the account can continue accumulating tax-free income and gains for the child's retirement years.[4]

Financing College With Deductible Payments From a Parent's Business

Clients operating sole proprietorships and husband-wife partnerships can employ their under-age-18 children as part-time (or full-time) help. Clients can then pay the children wages without owing *any* federal Social Security or Medicare taxes. Similarly, the child does not owe the employee's share of these taxes. In addition, there is no federal unemployment tax on under-age-21 children.[5]

The child can shelter up to $5,950 of 2012 wage income with his or her own standard deduction. Therefore, in many cases, the child will not owe *any* income tax on the wages. 2012 wages in excess of $5,950 will be taxed at only 10 percent or 15 percent up to taxable income of $35,350. The child can then save and invest some or all of the wages in his or her college account. This concept works only with responsible children who will actually invest the money, but under the right circumstances, the idea creates a triple tax break as follows:

- Parent gets a business deduction for amounts set aside for college expenses. The deduction lowers the parent's income tax *and* self-employment tax and reduces adjusted gross income (AGI), which can have other therapeutic side effects.
- There are no federal payroll taxes, and the child pays little or no income tax on the wages.

Obviously, the wages must be reasonable in relation to the work actually performed by the child. The best scenario involves teenagers who can actually be assigned meaningful duties that have some value (such as installing business software programs and teaching the parent how to use them).

When the parent's business is *not* a sole proprietorship or husband-wife partnership, the child's wages will be subject to Social Security, Medicare, and federal unemployment taxes,

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[4] See IRC sec. 72(t) and IRC sec. 408A.

[5] See IRC sec. 121(b)(3) and IRC sec. 3306(c)(5).

just like any other employee's. Social Security and Medicare taxes will also be due on wages paid to over-age-17 children employed by their parent's sole proprietorship business or husband-wife partnership. However, even when these payroll taxes apply, the overall tax benefit can still be substantial.

How a Closely Held Business Can Deduct College Expenses Paid for the Owner's Adult Child

Employer-sponsored educational assistance programs can deliver up to $5,250 in annual tax-free reimbursements to each eligible employee. The employer can deduct the costs whether the business is operated as a sole proprietorship, S or C corporation, limited liability company, or partnership. The education need not be job-related, and graduate courses are also allowable. This treatment is available under IRC Section 127. You may think the IRC Section 127 qualification rules mean no dice for employees who happen to be children of small business owners, but this is not necessarily true. A loophole exists for any child who is

- age 21 or older and a legitimate employee of the parent's business;
- not a more-than-5 percent owner of the business in his or her own right; and
- not a dependent of the parent (business owner).

Age-21-or-older status is even more likely when the student spends substantial time working in the parent's business. Working means the student has an income, making it more likely he or she will not be a dependent on the parent's return.

All in all, what starts off looking like a rather narrow loophole ends up being wide enough to drive a truck through for many small business owners.

Meeting the Qualification Rules

As mentioned, there are some qualification rules for IRC Section 127 educational assistance programs. Although they are not especially burdensome, they must be scrupulously followed. The rules include the following:

- The program must be set up under a written plan of the employer for the exclusive benefit of employees.
- The program must benefit employees who qualify under a classification scheme set up by the employer that does not discriminate in favor of highly compensated employees or their dependents. There is no discrimination problem if all the employees are eligible, even though they all happen to be members of the owner's family. If there are other employees, they may have to be covered as well.
- The program cannot offer employees the choice between tax-free educational assistance and other taxable forms of compensation (such as cash). In other words,

IRC Section 127 benefits cannot be included as an option in an IRC Section 125 cafeteria benefit program.
- The program need not be prefunded; the employer can pay or reimburse qualifying expenses as they are incurred by the employee (the owner's age-21-or-older child).
- Employees must be given reasonable notification about the availability of the program and its terms.
- The program cannot funnel more than 5 percent of the annual benefits to shareholders or owners, their spouses, or dependents. Only owners with more than 5 percent of the stock or more than 5 percent interests in capital or profits of the employer on any day during the year are tainted for purposes of this rule.

The last qualification rule is the real kicker. Can ownership be attributed to the owner's child—the student—when the child does not directly own more than 5 percent?

Dodging the 5 Percent Ownership Bullet

To avoid having the owner's child become disqualified under the immediately preceding rule, the child cannot own more than 5 percent of the business. This includes both actual ownership (such as via shares the child directly owns in his or her own right), plus attributed (indirect) ownership under rules explained in the following section.

Stock Attribution Rules

Stock ownership in the employer corporation is attributed to the owner's child if he or she owns options, is a 5 percent partner in a partnership that owns stock, or is a 5 percent shareholder in another corporation that owns stock.[6] These rules will rarely cause any attributed stock ownership problems.

Also, an under-age-21 child is considered to own any stock owned directly or indirectly by the parents. However, there is no attribution if the child is age 21 or older.[7] Actually, there is an attribution rule when an adult child has actual ownership of more than 50 percent of the stock of the employer corporation, but such actual ownership would probably disqualify the IRC Section 127 program before ever getting to the stock ownership attribution rules.[8]

In other words, unless the owner's over-age-21 nondependent child has actual direct ownership of more than 5 percent of the employer company's stock, he or she should pass all the tests. If so, the corporation can set up an IRC Section 127 program and start paying for—and deducting—college tuition costs right now. The child will owe $0 in federal income tax on amounts up to $5,250 per year.

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[6] IRC sec. 127(c)(4) and IRC sec. 1563(e)(1), (2), and (4).

[7] IRC sec. 1563(e)(6)(A).

[8] See IRC sec. 1563(e)(6)(B).

Ownership Attribution for Unincorporated Employers

If the business is unincorporated, clients still have to worry about ownership being attributed to the owner's child. The good news is the rules are analogous to the preceding ones for corporations. So, again, things should work out as long as the client's child does not have actual direct ownership of more than 5 percent of the capital or profits of the business.[9]

State-Sponsored Qualified Tuition Programs (Section 529 Plans)

Just a few years ago, only about a dozen states offered prepaid college tuition programs, and, frankly, they were not so hot. Granted, paying in allowed parents to lock in tuition costs for their child, thus avoiding tuition inflation that had been running well above the overall rate. But choices were usually limited to in-state public institutions. Plus, there was no upside if the prepaid account earned more than the tuition inflation rate.

Congress changed the landscape in 1996 by granting valuable tax breaks to so-called qualified tuition programs (QTPs) (also commonly called Section 529 plans).[10] The real news, however, is that most of the newer QTPs are *college savings plans*.

Section 529 plans are much more attractive than the old-fashioned prepaid tuition programs, but they deliver the same tax advantages. The best feature is that the tax benefits are not subject to any AGI-based phase out rules. The opposite is true for all the other widely publicized education tax breaks.

> **Key Point:** The super-beneficial federal tax rules for Section 529 plans were originally included in 2001 legislation. However, these favorable provisions (which include federal-income-tax-free treatment for qualified Section 529 plan distributions and favorable gift and estate tax rules) were scheduled to "sunset" after 2010. The Pension Protection Act of 2006 made all the existing rules permanent, which is good, however, the act also granted the IRS power to issue "anti-abuse" rules to prevent taxpayers from using Section 529 plans in tax-saving strategies that go beyond what Congress intended. For example, the government doesn't like the fact that individuals can currently use Section 529 plan accounts as estate tax avoidance vehicles while still retaining control over the how the funds are used.

How College Savings Plans Work

Parents, or grandparents, start the ball rolling by making contributions into a trust fund set up for the applicable state plan. The money goes into an account designated for the beneficiary specified by the contributor. (Usually, this is one's child, but it could be a grandchild or any

[9] Treas. Reg. 1.127-2(f)(2)(iii) states that the attribution rules under the IRC Section 414(c) regulations apply. Treas. Reg. 1.414(c)-4(b)(6) includes an ownership attribution rule that is essentially the same as the stock attribution rule explained earlier in this chapter. See also the example in Treas. Reg. 1.414(c)-4(b)(6)(iv).

[10] See IRC sec. 529 and related proposed regulations.

other person.) Contributions can be lump sums or installment pay-ins over several years. The trust fund then invests the account balance. Most savings plans will cover expenses at any accredited college or university in the country.

Simply put, these plans are really nothing more than a tax-advantaged way to save for college. Contributions do not guarantee college admittance (that is up to the student), they do not lock in the cost to attend college, and there is generally not a guaranteed minimum return on the investment. At college time, the account balance is available to pay for some or all of the designated beneficiary's eligible expenses.

QTP savings plans do offer significant tax benefits if the account earns the expected healthy profit over the years. They also offer upside potential. If the investment return exceeds the rate of inflation for college costs, parents will not need to contribute nearly as much to fully fund their child's account.

Finally, parents do not have to undergo the expense and hassle of setting up a Crummey trust in order to prevent their child from spending all his or her college money on a new red convertible. The QTP will disburse funds only to pay for verifiable eligible college expenses—and red convertibles do not meet the test In addition, parents can roll the QTP money over into an account for another child. Obviously, however, this is not an option when the child is an only child. (The issues surrounding only children are beyond the scope of this book.)

The Tax Benefits

Tax-wise, QTPs are a really great deal. Withdrawals to pay qualified college expenses are totally free of any federal income taxes. Even better, these federal tax breaks are available regardless if income. In contrast, most of the other college education tax breaks are phased out for higher-income taxpayers. As a final incentive, most states offer additional state income tax breaks to in-state QTP investors.

Amounts can be rolled over between accounts as often as once a year. So if a parent decides that the terms offered by some other state's QTP are better than the current plan, money can be rolled over from one plan to the other with no adverse federal tax consequences.[11] Also, IRS Notice 2001-55 states that QTPs can permit changes in the investment option selected for an account as often as once per calendar year or whenever the account beneficiary is changed. (This same rule will be included in yet-to-be-released final regulations under IRC Section 529.)

Amounts can be rolled over tax-free into an account set up for another beneficiary who is a family member of the original beneficiary. First cousins qualify as family members for this purpose.[12]

> **Warning:** Do not confuse QTP college savings plans with QTP prepaid tuition plans. The financial press seems to think all plans allowed under IRC Section 529 are college savings plans by definition. Wrong. IRC Section 529 also gives

[11] See IRC sec. 529(c)(3)(C).

[12] See IRC sec. 529(e)(2).

tax-advantaged treatment to state-sponsored prepaid tuition plans. However, most commentators agree these prepaid plans are inferior to savings plans, because with a prepaid plan, the account cannot earn more than the inflation rate for covered education costs. So no upside exists if the account actually earns more. With a savings plan, the investor reaps the benefits if the account earns more. Of course, there is no guarantee it *will* earn more. But it *should* if it is opened up far enough in advance of the beginning of the beneficiary's college career.

What about gift taxes, you ask? Each contribution counts as a gift by the contributor to the designated beneficiary, but it also qualifies for the $13,000 annual exclusion ($26,000 for joint gifts by a married couple). If parents want to dump in a big contribution in a single year, they can claim 5 years' worth of $13,000 exclusions in the contribution year. This permits lump-sum contributions up to $65,000 or up to $130,000 for joint gifts by married couples— with no gift-tax worries. There are no gift-tax consequences when an account balance is rolled over to a new account set up for another child or when an existing account is redesignated to benefit another child.

As for state income taxes, generally no one will owe any when both the contributor and the designated beneficiary reside in the state sponsoring the plan. Otherwise, the student may owe taxes at college time in his or her state of residence, which may or may not be where the school is located. In fact, unanswered questions about state taxes represent one of the few negatives about QTPs. It may take a few years before everything gets settled, however, it is clearly in each state's best interest to keep money from crossing the borders. That is why New York grants a state income tax deduction for contributions to its plan. Other states are following suit with incentives, but some may ultimately go with a punitive approach instead. For example, the contributor could be taxed annually on the account's earnings if he or she is disloyal enough to invest in another state's plan.

Investment Restrictions and Withdrawal Penalties

Under federal tax rules, neither the person making the contribution to a QTP college savings plan nor the designated beneficiary can direct how the money is invested once it has been forked over. The contributor can, however, select among different investment strategies that may be offered by the plan and change as often as once per calendar year.[13] For example, a plan could offer an aggressive strategy (for example, weighted toward equity mutual funds), a balanced strategy (for example, mix of equity and fixed-income), and a conservative approach (for example, strictly low-risk, fixed-income investments).

There are also limits on how much can be invested. Theoretically, one can contribute only what is needed to finance the designated beneficiary's future college expenses. IRS rules set the maximum as the actuarial estimate of today's dollars needed to fund future tuition, required fees, and room and board expenses for 5 years of undergraduate enrollment at the most expensive school covered by the program. Because most QTP savings plans cover any

[13] IRS Notice 2001-55.

school in the country (including Harvard and Stanford), this can be a big number. As this was written, most plans allowed contributions of more than $250,000.

The federal income tax rules also impose a 10 percent penalty on account earnings withdrawn for reasons other than

- to pay qualified higher education expenses,
- death or disability of the beneficiary, or
- to reflect receipt by the beneficiary of scholarships or other financial aid.

Computer and Internet Costs Are Qualified Expenses

Computer costs (including peripheral equipment and software) and Internet access charges and related costs count as qualified higher education expenses for purposes of receiving federal-income-tax-free distributions from Section 529 plan accounts. The expenses must be for computer and Internet use by the Section 529 plan account beneficiary (the student) during any of the years he or she is enrolled in an eligible educational institution. There is no problem if the student's family also uses the computer and Internet access. However, the cost of software designed for sports, games, and hobbies does not qualify for this break unless the software is mainly educational in nature.[14]

Which State Plan Is Best?

Your client must decide which plan is best based on how closely a plan's investment strategy conforms to his or her own preferences. Of course plans with low management fees are preferred, other things being equal. The good news is that many (if not most) qualified college savings plans are now clearly interested in attracting money from out-of-state investors. And competition is heating up, which is beneficial for investors. Generally, the only downside to investing in an out-of-state plan is the possible loss of state income tax benefits that may be offered by the in-state plan. If the client resides in a state without a personal income tax, the client is essentially a free agent. He or she can pick the best plan, even if it is an out-of-state plan, without any fear of adverse state income tax consequences.

Another interesting development is a growing trend toward professional management of qualified college savings plans. For example, the New Hampshire, Delaware, and Massachusetts programs are all managed by well-known Fidelity Investments. These plans invest contributions in a mix of Fidelity mutual funds, based on the number of years until the account beneficiary (the college-bound child) reaches college age. The New York plan follows a similar investment strategy and is managed by equally well-known TIAA-CREF. To find out more about a particular state's QTP college savings plan and to make comparisons between plans, visit www.savingforcollege.com.

In evaluating QTP college savings plans, clients should first look at the investment strategy. If they like what they see, there is no major downside other than possible state income tax

[14] See IRC sec. 529(e)(3)(A).

questions and the issue of fees. On the other hand, if parents feel they can earn much better returns investing on their own, the tax savings may not be worth the lost profits.

Deducting Section 529 Plan Losses

Many college savers have suffered significant losses on investments held in their Section 529 plan college savings accounts. If your clients are among them, they might be wondering if they can claim tax writeoffs. In fact, it is possible, but there are issues. IRS Publication 970, *Tax Benefits for Education*, and IRS Announcement 2008-17 both state that a Section 529 account owner can trigger a tax loss when he or she shuts down a loser account. The owner of a Section 529 account is the person who controls the account, which usually means the contributor. Unfortunately, there is no other official or unofficial IRS guidance on the subject of Section 529 plan losses. That said, the author feels relatively comfortable in piecing the relevant rules together and disbursing the following conclusions.

An account owner has a tax loss when both of the following conditions are met:

1. He or she liquidates all Section 529 college savings accounts set up for the same beneficiary (college-bound individual) that he or she owns under a particular state's plan.[15] When there is just one Section 529 account for each beneficiary (which is the usual situation), the account owner need not worry about this issue.
2. The total proceeds from liquidating the account(s) are less than the owner's total tax basis in the account(s). (See IRS Publication 970.) The tax basis of each account equals the amount contributed to that account reduced by basis amounts included in any earlier withdrawals taken from that account. In the simplest scenario when there is only one account for the applicable beneficiary which has never been dipped into and which is now worth less than what was contributed, the account owner has a tax loss if he or she liquidates the account.

IRS States Miscellaneous Itemized Deduction Treatment Applies

According to the IRS, a Section 529 account tax loss is classified as a miscellaneous itemized deduction.[16] As such, the loss gets thrown in the pot with other miscellaneous itemized deduction expenses, such as fees for investment advice and tax preparation. Only the excess of total miscellaneous itemized deductions over 2 percent of AGI can be claimed as a writeoff on Schedule A of Form 1040.[17] If the client files jointly with his or her spouse, the 2 percent threshold is based on the couple's joint AGI.

If your client clears the 2 percent-of-AGI hurdle, he or she is still not home free. The client may lose part of his or her miscellaneous itemized deduction writeoff due to the phase-out

[15] See IRS Notice 2001-81 and Prop. Reg. 1.529-3(d) which, taken together, indicate that withdrawals from all accounts set up by the same owner for the same beneficiary with the same state plan must be aggregated to determine the federal income tax consequences of withdrawals.

[16] See IRS Publication 970 and Announcement 2008-17.

[17] See IRC sec. 67.

rule for higher-income individuals.[18] Finally, miscellaneous itemized deduction writeoffs are completely disallowed for alternative minimum tax (AMT) purposes. If your client is an AMT victim, some or all of the anticipated tax savings from IRA losses will go up in smoke.[19]

> **Warning:** Once your client liquidates a Section 529 account, his or her ability to quickly put money back into another Section 529 account may be limited by the considerations mentioned later in this chapter.

Example 9-9

Doris owns one Section 529 plan account that she set up in 2007 for her college-bound child. To jump start the account, she made a lump-sum contribution of $60,000, which she chose to spread out over 5 years for federal gift tax purposes. No withdrawals have been taken from the account, which is now worth only $45,000. In 2012, Doris is considering liquidating the account, because she believes it would generate a deductible tax loss. Plus, she wants her money back.

Account Liquidation Results: Because no withdrawals have been taken, the basis of the account equals the $60,000 that Doris contributed. Therefore, liquidating the account would trigger a $15,000 tax loss ($60,000 basis – $45,000 proceeds).

Deductible Loss Calculation: The IRS states that Doris must treat the $15,000 loss as a miscellaneous itemized deduction subject to the 2 percent of AGI thresholdHer AGI is $150,000, so the threshold is $3,000 ($150,000 × 0.02). Doris also has $1,500 of other miscellaneous itemized deductions for a total of $16,500 ($15,000 Section 529 loss + $1,500). Therefore, on her Schedule A, Doris can claim a miscellaneous itemized deduction of $13,500 ($16,500 – $3,000). However, if she is a victim of the AMT (which she is not for purposes of this example), the deduction is disallowed in the AMT calculation. Her actual tax savings may be little or nothing.

Bottom Line: In this example, liquidating the Section 529 account triggers an itemized deduction of $13,500, which will reduce taxable income by that amount. If Doris is in the 28 percent federal income tax bracket, the deduction will cut her federal income tax bill by $3,780 (0.28 × $13,500). Plus, she gets her money back (what is left of it).

Mind These Other Considerations Too

Liquidating a Section 529 account can have additional tax implications that must be considered.

Client May Have to Repay State Income Tax Benefits

If your client collected a state income tax deduction or credit when he or she invested in his state's Section 529 plan, shutting the Section 529 account down could mean that he or she will have to recapture a previously-claimed deduction by reporting it in income on his or her state tax return or repay a previously claimed credit.

[18] See IRC sec. 68.

[19] See IRC sec. 56(b)(1)(A)(i).

Client May Be Giving Up Tax-Free Recovery

Sometimes doing nothing turns out to be a pretty good strategy. If your client's low-earning Section 529 account recovers and once again becomes worth more than he or she contributed, assuming he or she eventually drains the account to pay for qualified college costs, he or she will not owe any federal income tax on the difference between what the account is worth now and the higher value after the recovery. On the other hand, if your client shuts down the account now and claims a tax loss, it may not be worth as much as he or she expected for the reasons explained previously. If he or she then continues to invest for college in a taxable account, the resulting income and gains will be taxed, unless he or she has losses to shelter them.

Client Should Not Reinvest Too Quickly

When a client liquidates a Section 529 account and is lined up to successfully reap some tax savings under the rules explained previously, he or she should be advised against reinvesting in another Section 529 account set up for the same beneficiary (or for another beneficiary who is a member of the same family) within 60 days after the date the first account is liquidated. Otherwise, the client will apparently be deemed to have simply rolled over proceeds from one Section 529 account into another in a tax-free transaction, and some or all of his or her loss deduction will go out the window.[20]

Beware of Gift Tax Implications If Client Reinvests

When a client contributes to a Section 529 account, he or she is treated as making a gift to the account beneficiary (the donee, who is usually a child or grandchild) under the federal gift tax rules. However, there are no adverse gift tax consequences as long as the annual contribution plus any other gifts to the donee do not exceed the annual gift tax exclusion amount ($11,000 for 2002–5; $12,000 for 2006–8; $13,000 for 2009–12). If client and spouse make joint gifts, the annual exclusion amount for each donee is effectively doubled. However, if annual gifts to a donee exceed the exclusion amount, the excess reduces the donor's $5.12 million unified federal gift and estate tax exemption (for 2012) dollar for dollar, which is not good if the donor hopes to make big gifts in the future.

Under a special rule, the donor is allowed to make a lump-sum Section 529 plan contribution and spread it out over five years for gift tax purposes.

For instance, in the preceding example, Doris made a $65,000 lump-sum contribution in 2009 and spread it out over 2009–13 with $13,000 allocated to each year. That way, the $65,000 contribution is fully sheltered by her annual gift tax exclusions for 2009–13, and her $5.12 million unified federal gift and estate tax exemption is fully preserved.[21]

However, if Doris liquidates the Section 529 account in 2012, the IRS might state that, with respect to the donee child (the account beneficiary), Doris has already used up $13,000 of her annual gift tax exclusion for 2012 and $13,000 of her exclusion for 2013. If Doris

[20] See IRC sec. 529(c)(3)(C)(i).

[21] See IRC sec. 529(c)(2) and Prop. Reg. 1.529-5.

contributes to a new Section 529 account set up for the same child, the contribution might be treated as a new gift to that child. If so, Doris would have to wait until 2014 to reinvest a meaningful amount in a new Section 529 account for the same child unless Doris does not mind using up part of her $5.12 million unified federal gift and estate tax exemption.

> **Key Point:** The potential gift tax implications from shutting down a Section 529 account and then contributing to a new account set up for the same beneficiary are not crystal clear. The issue discussed in the preceding paragraph may or may not be an issue in the eyes of the IRS. That said, clients should be informed of the possibility.

Conclusion on Deducting Section 529 Plan Losses

The seemingly simple question of whether Section 529 plan losses can be deducted is not so simple. Considering the whole picture, the clearest argument for shutting down a low-performing account is when the client simply wants (or needs) his or her money back and does not intend to reinvest in another Section 529 account because he or she has become disenchanted with the concept.