INDIVIDUAL TAXPAYER ISSUES

1

Corrections for all chapters and the *2006 National Income Tax Workbook Update* are available at `http://www.taxworkbook.com` (User Name: class2006 Password: class2006).

ISSUE 1: CANCELLATION OF DEBT Many taxpayers caught in the web of financial distress do not realize that a creditor's cancellation of debt can result in taxable income. This issue looks at IRS Form 1099-C, Cancellation of Debt, and its tax implications.

Form 1099-C

Form 1099-C is issued by a creditor when a debt of $600 or more is forgiven or canceled as a result of an identifiable event. Identifiable events include (but are not limited to) a bankruptcy discharge, extinguishment in probate, an agreement between the parties to reduce or cancel the debt, the creditor's decision to discontinue collection action and abandon the debt, and the expiration of a nonpayment testing period of 36 months or longer.

The fact that a Form 1099-C is issued by a creditor, however, does not automatically mean that the entire amount is taxable to the debtor. Form 1099-C must be filed regardless of whether the debtor is required to report the debt as income. Issuance of the form does mean that the debt cancellation needs to be addressed on the debtor's tax return.

Box 2 shows the amount of debt that was canceled. The reported amount may be the total amount owed to the creditor (including principal, interest, fees, penalties, administrative costs, and fines) or, for a lending transaction, it may be only the stated principal amount. (A lending transaction involves a monetary transfer from the creditor to the debtor, or on behalf of the debtor. It includes transfers using revolving credit and lines of credit.)

If an interest amount is included in the total debt shown in box 2, it must also be shown separately in box 3. When determining how much of the canceled debt is treated as income, any interest that would have been deductible on the debtor's return if it had been paid is excluded from income [I.R.C. §108(e)(2)]. Because personal interest is not deductible, it is included in cancellation of debt income. Because the issuer of the form does not necessarily know the debtor's tax consequences, the interest information is provided on Form 1099-C so that it can be considered when preparing the debtor's tax return.

If the taxpayer's bankruptcy is the reason for the debt cancellation, box 6 is checked. If property is repossessed along with a debt cancellation, the property's fair market value is entered in box 7.

Reporting Taxable Income

A Form 1099-C does not have to be issued if the canceled debt is less than $600, but the canceled debt is still included in gross income under I.R.C. §61, unless it qualifies for exclusion under I.R.C. §108. If the canceled debt must be included in income, where is it reported? Income from cancellation of an individual's nonbusiness debt is reported as other income on line 21 of Form 1040, U.S. Individual Income Tax Return.

Example 1.1 Reporting Cancellation of Debt Income

Irene discovered that she could obtain lower interest rates and postpone paying her personal credit card debt by transferring balances from one card to another. By 2006 she had a total debt of $15,430, including $3,125 of interest, $1,000 of penalties, and $11, 305 of principal. Irene was not insolvent or in bankruptcy: She just did not handle her finances well. After negotiating with the card issuer, Irene borrowed $11,305 from her bank to pay off the principal amount owed on the card. The credit card company canceled the card at her request and issued a Form 1099-C (see Figure 1.1), showing the $4,125 remaining balance (the accrued interest and penalties) in box 2.

Question 1. What does Irene include in gross income?

Answer 1. Because personal interest expense and credit card penalties are not deductible, the difference between the amount Irene paid and the total balance she owed is treated as income. Irene's Form 1040 must include the $4,125 as cancellation of debt income on line 21.

Observation Deduction of Interest on Bank Loan

If the bank loan Irene took out to pay the credit card company is a home equity loan or a line of credit secured by her home, she may be able to deduct the interest she pays in the future on the bank loan as qualifying home mortgage interest.

Question 2. What if Irene had charged items that she could have deducted on her return? Would that change things?

Answer 2. Remember that Irene paid the principal amount on the card, and the only debt that was canceled was interest and penalties. Interest and penalties accrued on business debt are deductible as business expenses; therefore, forgiveness of those amounts is excluded from income under I.R.C. §108(e)(2).

In contrast, a credit card company's forgiveness of the principal portion of a business debt frequently results in taxable income because the taxpayer has already deducted the expense paid with the credit card. When a cash-basis taxpayer pays a business expense with a credit card, he or she is treated as paying with cash. If Irene's canceled debt consisted of prior year charges for business expenses, she has deducted those expenses on the prior year's return, and she must therefore apply the tax benefit rule of I.R.C. §111 to determine any potential income inclusion before an I.R.C. §108 exclusion is considered (Rev. Rul. 70-406, 1970-2 C.B. 16).

FIGURE 1.1 Form 1099 (Example 1.1)

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code **Rocky Mountain National Bank** **100 Mile High Drive Denver,** **CO 80224**			OMB No. 1545-1424 **2006** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S federal identification number **01-1081099**	DEBTOR'S identification number **108-10-1099**	**1** Date canceled **05/17/2006**	**2** Amount of debt canceled $**4,125**	**Copy B** **For Debtor**
DEBTOR'S name **Irene Dunn**		**3** Interest if included in box 2 $**3,125**	**4**	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.) **1099 Apple Lane** City, state, and ZIP code **Valley, MI 48224**		**5** Debt description **Credit card debt**		
Account number (see instructions)		**6** Bankruptcy (if checked) ☐	**7** Fair market value of property $	

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

Two Tax Court summary opinions issued in 2006 speak directly to credit card debt. In *Scott v. Commissioner,* T.C. Summary Opinion 2006-16, the taxpayers claimed that the instructions to Form 1099-C required only the principal to be taken into account in calculating cancellation of debt income. The court found to the contrary, explaining that for credit card debt (which it categorized as a nonlending transaction) the entire balance is included. The taxpayers also argued that the credit card company had agreed that the actual debt owed was the reduced amount paid. The court found no evidence of a contested debt. In rejecting the taxpayers' testimony (which the court called self-serving), the court noted that the credit card company's action of issuing a Form 1099-C showed that the company did not see acceptance of the smaller amount as an agreed upon reduction in charges.

Martins v. Commissioner, T.C. Summary Opinion 2006-43, also involved a credit card balance. In this case, the taxpayer negotiated an agreement to pay $15,000 in exchange for a release from a $21,831.38 debt. The taxpayer claimed that the reduction of the debt was a settlement of disputed amounts The court noted that there is a difference between a compromise or settlement of a disputed amount of debt and an agreement to pay a certain amount in return for the rest of the debt being written off. It held that there was no amount in dispute and that Martins had $6,831.38 cancellation of debt income. Martins also claimed he did not have income because he did not receive the Form 1099-C. The court dismissed that argument as well, explaining, "The nonreceipt of a Form 1099 does not convert a taxable item to a nontaxable item."

Planning Pointer Application of Partial Payment

To prevent a dispute over what portion of the debt was paid and what portion was canceled, an agreement to settle a business debt for less than the full amount should specify the allocation of the payment to principal, interest, and any other fees.

If the application of a partial payment is not specified in an agreement to settle the debt, the allocation is determined by the terms of the loan agreement, if any. Loan agreements often apply payments first to interest and then to principal. When that is the case, the settlement payment is first treated as going to interest and then to principal. Any remaining interest or principal is treated as being canceled.

If the loan agreement does not address the allocation of payments, the general rule for nontax debts is that a voluntary partial payment is applied first to interest and then to principal [*Motel Corporation v. Commissioner,* 54 T.C. 1433 (1970)]. However, if a debt is settled for a lump sum, an interest deduction is allowed only if the settlement amount exceeds the principal amount of the debt [*Petit v. Commissioner,* 8 T.C. 228 (1947)]. In addition, if a debtor is insolvent, and the proceeds of a foreclosure do not cover the loan principal, the proceeds are applied first to principal and then to interest [*Newhouse v. Commissioner,* 59 T.C. 783 (1973)]. This prevents a creditor who cannot recover the full amount of principal from being required to recognize interest income.

Exceptions to Income Inclusion

Although cancellation of debt is normally taxable, several exceptions can eliminate the income or substantially decrease it. The exceptions are based on financial distress or occupational activity.

Bankruptcy

If the debt is canceled in a bankruptcy proceeding, the cancellation is excluded from income under I.R.C. §108(a)(1)(A). But this doesn't mean that the bankruptcy results in a free pass for tax purposes. Bankrupt taxpayers must include Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), with their federal income tax returns, and they must reduce certain tax attributes by the excluded income.

The tax attributes (carryover losses, carryover credits, and basis in property) generally are decreased in the order listed in Figure 1.2. However, taxpayers with multiple types of tax attributes may choose between reducing the basis of depreciable property first or reducing carryover losses, credits, and basis in the order shown. When one attribute has been eliminated, the remaining exclusion is then used to reduce the next item on the list.

FIGURE 1.2 Tax Attributes*

1. Net operating losses: Reduce dollar for dollar.
2. General business credit carryover: Reduce one dollar for each three dollars of excluded debt.
3. Minimum tax credit carryover: Reduce one dollar for each three dollars of excluded debt.
4. Capital loss carryovers: Reduce dollar for dollar.
5. Basis of assets: Reduce dollar for dollar.
6. Passive activity loss and passive activity credit carryover: Reduce dollar for dollar for loss and one dollar for each three dollars of excluded debt for credit carryover.
7. Foreign tax credit carryover: Reduce one dollar for each three dollars of excluded debt.

*If a taxpayer has both current year losses to carry forward and losses being carried forward from prior years, the losses arising in the tax year of the debt cancellation are reduced first, followed by the carryovers in the order of the tax years from which they arose, starting with the earliest year. Credit carryovers are reduced in the order in which the carryovers are taken into account for the tax year of the debt cancellation.

A taxpayer whose excluded debt exceeds the available tax attributes may still exclude all of the debt if it is discharged in a bankruptcy case. This is likely to be the case for a wage earner whose only tax attribute is basis in nondepreciable property (such as a personal residence or automobile).

Example 1.2 Reduction of Tax Attributes

As a result of Bill and Donna's bankruptcy, they have $42,000 in canceled debt for 2006, primarily from medical bills. Bill operates a small contracting company, with $215,000 of revenue in 2006 and $195,000 of expenses, not including depreciation. Donna received a Form W-2 showing $22,000 of wage income. The business's only assets are depreciable personal property with a $52,000 total adjusted basis at the beginning of 2006. The depreciation for 2006 is $7,000. The couple's 2005 return showed a $12,000 NOL that they elected to carry forward. Their only adjustment to income for 2006 is the deduction for half of Bill's self-employment tax.

Question 1. How much of the $42,000 cancellation of debt is reported in income in 2006?

Answer 1. None of it. They meet the bankruptcy exception.

Question 2. What effect does the exclusion have on their tax attributes for 2006 (the Form 1099-C year)?

Answer 2. Reductions to tax attributes aren't made until after the current year's tax is calculated, so they can use their $12,000 NOL and $7,000 depreciation on their 2006 tax return. Factoring in the depreciation gives Bill a net income of $13,000 ($215,000 – $195,000 – $7,000). Adding his profit to Donna's wages gives them a total income of $35,000, which is reduced to $23,000 by the $12,000 NOL carryover.

Their only remaining tax attribute is basis in both business and personal-use property. Treas. Reg. §1.1017-1(a) requires the bases of property used in the business to be reduced before the bases in personal-use property. After $7,000 of 2006 depreciation is subtracted, the adjusted basis of the business assets is $45,000 ($52,000 – $7,000).The $42,000 of canceled debt reduces the depreciable basis to $3,000 ($45,000 – $42,000). If the assets are sold in a later year, the $42,000 reduction in basis due to the $42,000 debt cancellation is treated as allowed or allowable depreciation for I.R.C. §1245 recapture, even though Bill was not able to take a deduction for it.

Form 982, shown as Figure 1.3, should be attached to Bill and Donna's 2006 return to show the basis reduction.

Question 3. Does it make any difference if the assets are not fully paid for?

Answer 3. It might. They are allowed to retain an aggregate basis in all assets equal to the aggregate debt that remains after bankruptcy. The purpose of this rule is to leave the taxpayer in the position of not having any gain to report if the remaining assets are sold for an amount equal to the remaining debt. However, the limit on reducing basis is not calculated item by item. If the total of all of their debt after the discharge is $33,000, they are allowed to keep $33,000 of basis in all of their assets. They must follow the ordering rules discussed in Answer 2, and they can stop reducing basis when the aggregate basis is reduced to $33,000. For example, assume that the Bill and Donna have a $22,000 basis in all of their assets other than the depreciable business assets. They would have to reduce the basis of the depreciable business assets from $45,000 to $11,000–leaving them a total of $33,000 of basis ($11,000 in business assets and $22,000 in personal-use assets). Even though basis is reduced by only $34,000 ($45,000 – $11,000) they do not have to recognize the $8,000 difference between the $42,000 canceled debt and the $34,000 basis reduction.

Cross-Reference Tax Planning in Financial Distress

Note that the reduction of tax attributes is made **after** taxes are calculated for the year of the debt discharge. See Issue 3 in Chapter 20, Financial Distress, of the *2005 National Income Tax Workbook* for examples of planning to use the attributes in the year debt is discharged.

Insolvency

Not all taxpayers with financial problems file for bankruptcy. Debtors may just negotiate with lenders to accept a lesser amount. The taxability of such a transaction depends upon the amount of the taxpayer's insolvency. If the amount of the insolvency (the excess of liabilities over assets) is more than the amount of debt canceled, the cancellation of debt is not taxable. However, the taxpayer must reduce tax attributes in the same manner as a taxpayer in bankruptcy.

FIGURE 1.3 Form 982 (Example 1.2)

Form **982**
(Rev. January 2006)
Department of the Treasury
Internal Revenue Service

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

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

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

Name shown on return	**Identifying number**
Bill and Donna Bankrupt	108-01-0982

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

1 Amount excluded is due to (check applicable box(es)):
a Discharge of indebtedness in a title 11 case . . . ☑
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . ☐
c Discharge of qualified farm indebtedness . . . ☐
d Discharge of qualified real property business indebtedness . . . ☐
e Discharge of certain indebtedness of a qualified individual by reason of Hurricane Katrina . . . ☐
2 Total amount of discharged indebtedness excluded from gross income . . . | 2 | 42,000
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . ☐ Yes ☐ No

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

Enter amount excluded from gross income:		
4 For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property . . .	4	
5 That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property . . .	5	
6 Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge . . .	6	
7 Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8 Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge . . .	8	
9 Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge . . .	9	
10 Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness* . . .	10	42,000
11 For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5 . . .	11a	
b Land used or held for use in a trade or business of farming . . .	11b	
c Other property used or held for use in a trade or business, or for the production of income . .	11c	
12 Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13 Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge . .	13	

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

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

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

For Paperwork Reduction Act Notice, see page 3 of this form. Cat. No. 17066E Form **982** (Rev. 1-2006)

Example 1.3 Calculating Insolvency

Susan found herself in over her head, financially speaking, with $23,000 in consumer debt. She applied for a consolidation loan to bring her payments down to a more manageable level, but her bank would lend her only $18,000. In a panic, she worked out a deal with her other creditors to accept the $18,000 and to cancel the rest of the $23,000 debt. Susan's only asset is her condo, which has a fair market value (FMV) of $77,000. Her liabilities after the discharge are a $62,000 mortgage and the $18,000 she now owes the bank. She received several Forms 1099-C showing a total of $5,000 in box 2. She has no tax attributes other than a $70,000 basis in her condo.

Question 1. Was Susan insolvent before her debt was forgiven?

Answer 1. Yes, she was insolvent in the amount of $8,000 [the $85,000 total of the mortgage ($62,000) and the consumer debt ($23,000) minus the $77,000 FMV of the condo].

Question 2. What does she report on her return?

Answer 2. Susan can exclude the entire $5,000 of canceled debt because it does not exceed her $8,000 insolvency.

Question 3. Does she reduce her tax attributes by the full $5,000?

Answer 3. No, because basis reduction is limited to the excess of her basis ($70,000) over her remaining debt ($62,000 + $18,000 = $80,000) after the debt was canceled. Because her remaining liabilities still exceed her basis, she is not required to reduce the basis in her property, and she has no other tax attributes.

Question 4. Houses are exempt property for bankruptcy in my state. Why does she even have to consider the house?

Answer 4. Insolvency for purposes of this exception is determined by federal tax law, not by state law. There are no exempt assets for determining insolvency. Thus, pension plans must be included, as well as the full value of assets held as tenants by the entirety. Separate assets of a spouse are not considered, however, if the debt was owed only by the other spouse.

Practitioner Note — Purchase Price Adjustments

If a debt arising from the purchase of property is owed by the original buyer to the original seller, a subsequent reduction of the balance due is a price adjustment, not a cancellation of debt, unless the debtor is insolvent or in bankruptcy [I.R.C. §108(e)(5)]. The price adjustment exception to inclusion of income is not available if either the property or the debt has been transferred to a third party.

Specialized Exceptions

Three remaining exceptions to income inclusion apply only to specific situations: student loans, farm debt, and business real estate debt.

Student Loans

In general, cancellation of a student loan results in taxable income. However, I.R.C. §108(f) provides an exception for certain loans made by government agencies, educational institutions, and public hospital organizations if the loan contains a provision for cancellation of the debt in return for the recipient's working for a stated period of time in a designated public-service profession. Doctors and other medical professionals who practice in rural areas where there are shortages of medical help can qualify for this program, as can teachers who accept assignments in inner city school systems.

The provision can apply to refinanced loans, as well as to original loans for qualified educational expenses, but the loan contract must contain this qualifying clause. Tax attributes are not reduced, and solvency is not an issue.

Practitioner Note — Working for the Loan Provider

A canceled student loan is taxable income if the services are performed for the organization that made the loan. The exception is not available when there is an employee-employer relationship between the lender and the borrower.

Qualified Farm Debt

A solvent taxpayer with indebtedness incurred directly from operation of a farming trade or business can exclude cancellation of debt income under I.R.C. §108(a)(1)(C). The taxpayer must be actively engaged in farming. That requirement is met if at least 50% of the taxpayer's aggregate gross receipts came from farming during the three years preceding the year of discharge. This exclusion requires reduction of tax attributes, so that any remaining debt cancellation becomes taxable after the tax attributes are reduced to zero [I.R.C. §108(g)(3)].

The ordering rule for reduction of basis is different from the rule for insolvency and bankruptcy reductions. Only the basis of qualified property (property used or held for use in a trade or business or for the production of income) can be reduced, and it is reduced in the following order: depreciable property, land used or held for use in farming, and other qualified property. The basis of personal-use property cannot be considered.

Qualified Real Property Debt

This exception can apply to solvent taxpayers except for C corporations. I.R.C. §108(a)(1)(D) provides an elective exclusion for acquisition debt (including refinanced acquisition debt) that is canceled when the FMV of the business real property securing the debt has fallen to a value that is less than the debt itself. The maximum exclusion is limited in two ways:

1. It cannot be more than the excess of the outstanding loan principal over the FMV of the property immediately before the debt cancellation.
2. It cannot exceed the taxpayer's remaining aggregate adjusted basis for all depreciable real property that was held before the discharge. The remaining basis is figured after reduction for depreciation in the debt discharge year, and after reductions for cancellation of debt income excluded by reason of bankruptcy or insolvency.

The qualified real property debt exclusion cannot be used for debt that qualifies for the farm debt exclusion.

Practitioner Note Election Required

Generally, the exclusions under I.R.C. §108 are mandatory. However, a taxpayer must make an election to reduce basis and exclude income from cancellation of qualified real property business indebtedness. The election is made by filing Form 982 with a timely filed (including extensions) income tax return for the year the debt was discharged (Treas. Reg. §1.108-5).

Questions and Answers

Question 1. What happens if my client can't make the payments on her mortgage, and she just gives the house back to the lender? She can't sell it for enough to pay off the mortgage.

Answer 1. If the bank is willing to treat the debt as fully paid in exchange for your client's voluntary return of the property, the transaction is treated as two different transactions: a sale of your client's house for its FMV and a cancellation of the debt that exceeds the FMV of the house. Both transactions are reported by the lender to your client and to the IRS on Form 1099-C.

Your client will have either a capital gain that could qualify for exclusion under I.R.C. §121 or a nondeductible capital loss on the deemed sale, because it is her personal residence. This gain or loss is the difference between the property's value (box 7 of Form 1099-C) and your client's adjusted basis in it (not shown on Form 1099-C).

The cancellation of debt income is the amount of debt that exceeds the property's FMV (usually box 2 minus box 7 of Form 1099-C). Unless your client is insolvent, it will be taxable to her.

Question 2. If the cancellation of debt is not taxable to my client, how do I report that on her return?

Answer 2. Because Form 1099-C is sent to the IRS, the cancellation of debt reported on it must be addressed on the return. If the debt cancellation is excludable, you must reduce your client's tax attributes by the amount of the excluded debt. Filing Form 982 shows why your client does not owe tax on the excluded amount, as well as how you are reducing any tax attributes she may have.

Question 3. My client owns a consulting business, and he isn't really in the business of lending money. But he sometimes has to give up on accounts receivable. Should he issue Form 1099-C?

Answer 3. Probably not. A creditor's bad-debt write-off doesn't always trigger an information return filing requirement. The IRS instructions for Form 1099-C state that it should be filed **only** by the entities that are required to file it. Before 2005, only certain financial institutions and government entities were required to issue a Form 1099-C. Now, any entity that has a significant trade or business of lending money is required to report debt cancellations.

A lending activity is significant if the entity lends money on a regular and continuing basis during the calendar year. It is significant under safe harbor rules if the entity meets one of two tests of income from lending (Treas. Reg. §1.6050P-2). The two tests are:

1. In the most recent test year, the entity's gross income from lending money is at least 15% of its gross income**, or** it is at least $5 million. This applies if the entity was not required to file Form 1099-C in the prior year.
2. In each of the three most recent test years, the entity's gross income from lending money is at least 10% of its gross income, **or** it is at least $3 million. This applies if the entity was required to file Form 1099-C in the prior year.

A test year is a taxable year of the entity ending before July 1 of the previous calendar year. Thus, a calendar year taxpayer will not have a safe-harbor test year until its third year of existence.

Question 4. My client refused to pay a disputed billing, and the other guy sent him a Form 1099-MISC. Is this income?

Answer 4. It depends. If your client received something of value that wasn't intended as a gift, he does have cancellation of debt income under I.R.C. §61(a)(12). If the expense would have been deductible if he paid it, he can exclude that income under I.R.C. §108(e)(2). If the value is the disputed issue, an explanation needs to be attached to the return.

ISSUE 2: HEALTH SAVINGS ACCOUNTS With health care costs rising and health plan options somewhat overwhelming, I.R.C. §223 Health Savings Accounts (HSAs) are being promoted as a means of providing tax-favored treatment for current medical expenses and as a way to save on a tax-favored basis for future medical expenses. This issue discusses several pros and cons of HSAs after recapping the basic rules.

The Basics

A prerequisite to funding a *health savings account* is coverage under a *high deductible health plan* (HDHP), which requires the policyholder to pay a higher than traditional amount (the deductible) before receiving plan benefits. In return, the premiums are less than premiums for policies with lower deductibles. For 2006, the minimum annual HDHP deductible is $1,050 for self-only coverage and $2,100 for family coverage. The taxpayer's total financial exposure is limited, however: The maximum allowable out-of-pocket cost, including both deductibles and co-pays (but not the premium for the policy) is $5,250 for self-only coverage and $10,500 for family coverage.

An HDHP may provide preventive care benefits without a deductible or with a deductible below the minimum annual deductible for other health care payments. Preventive care includes, but is not limited to, the following health services:

- Periodic health evaluations, including tests and diagnostic procedures ordered in connection with routine examinations, such as annual physicals
- Routine prenatal and well-child care
- Child and adult immunizations
- Tobacco cessation programs
- Obesity weight-loss programs
- Certain screening services

Preventive care generally does not include treatment of an existing illness, injury or condition, but certain drugs and medications can be considered preventive care. These include drugs taken by a person who has developed risk factors for a disease that has not yet manifested itself or to prevent recurrence of a disease. An example is cholesterol-lowering medication for an individual with high cholesterol.

An HSA is a medical expense savings plan that in many ways is similar to an IRA. Allowable contributions are deductible as an adjustment to gross income if they are made by the account owner, and they are excludable from income if they are made by the owner's employer. The maximum contribution amount for 2006 is the lesser of the HDHP deductible or $2,700 for self-only coverage ($5,450 for family coverage). A qualifying person who is at least age 55 at the end of 2006 may contribute an additional $700 to the HSA. There is no earned income requirement or maximum income limitation for HSA contributions and deductions. Allowable contributions are prorated if the qualifying HDHP coverage begins after the beginning of the tax year.

Personal Qualifications

Although anyone may be covered under an HDHP, not everyone qualifies to contribute to an HSA. A qualifying individual can have no other health care coverage in addition to the HDHP (except permitted coverage), cannot be enrolled in Medicare, and cannot be eligible to be claimed as a dependent on someone else's tax return. If a married person meets these requirements, he or she is an eligible individual even if his or her spouse has non-HDHP coverage for other family members. If both spouses are eligible, each may establish an HSA, but they cannot have a joint HSA.

Permitted coverage is additional insurance that provides benefits only for the following items:

- Workers' compensation claims, tort liabilities, or liabilities related to ownership or use of property
- A specific disease or illness
- A fixed amount per day (or other period) of hospitalization
- Coverage for accidents, disability, dental care, vision care, or long-term care

Practitioner Note HDHP without an HSA

Some clients who qualify for an HSA nevertheless may have an HDHP without establishing an HSA. This occurs because the HDHP was chosen for its lower premium, but the client did not choose to set aside the money for the savings account. In this case, the medical costs incurred are deductible only on Schedule A (Form 1040) and only if they exceed 7.5% of the client's adjusted gross income (AGI).

Tax Treatment

Distributions from an HSA are not taxable if they are used exclusively for qualified medical expenses. Funds can be withdrawn for qualified medical expenses at any time, even during the year of contribution, without a tax consequence. Amounts paid or reimbursed from an excluded HSA distribution **cannot** also be deducted on the Schedule A (Form 1040) as a medical expense.

Distributions that aren't used for qualifying expenses are included in income. They are also subject to an additional 10% tax, unless the owner is disabled, age 65, or deceased.

Any balance remaining in an HSA at the end of the current year carries over to the next year. Both the principal and the interest earned are tax-deferred as long as they remain in the HSA. This is true even if the owner is no longer eligible to make HSA contributions. The account can be rolled over to another HSA with the same owner. A rollover must be completed within 60 days after the funds are withdrawn, and only one rollover contribution can be made to an HSA during a one-year period.

If the account is inherited by a spouse, it continues to be an HSA; if anyone else inherits it, the account is no longer an HSA, and its full fair market value must be included in the beneficiary's income in the year of the owner's death.

Qualified Medical Expenses

Qualified expenses include almost all of the expenses that normally are deductible as medical and dental expenses on Schedule A (Form 1040). Premiums for the HDHP are **not** considered qualified expenses, but premiums for some other policies do qualify. These include otherwise deductible premiums for long term care insurance, health care coverage while the HSA owner is receiving unemployment compensation benefits, continuation coverage under COBRA, and Medicare and other coverage for an individual age 65 or older (except for Medicare supplemental policies).

Qualified medical expenses can be incurred no earlier than the date the taxpayer is first covered by an HDHP. Expenses incurred after the HSA owner is no longer eligible to make contributions may still be the basis for qualified distributions.

Example 1.4 HSA Contributions

Joe and Cathy have four children. Cathy does not work outside the home. Both parents are in their mid-30s. Joe's employer offered an HDHP with an HSA for 2006, with the employer funding half of the allowable contribution to each employee's account. The employee must pay the premium for the HDHP. Joe enrolled his family in the HDHP for the entire year.

Question 1. How should the employer contribution be reported on Joe's return?

Answer 1. It should be reported in box 12 of Joe's Form W-2, Wage and Tax Statement, coded W, but it should be excluded from box 1. Joe must file Form 8889, Health Savings Accounts, to report the contribution. He cannot take a deduction for the contribution because it was made with pre-tax money.

Question 2. If Joe's family coverage deductible is $2,400, and his employer puts half of that ($1,200) into Joe's HSA, what happens if Joe contributes the other half to the HSA?

Answer 2. Because Joe's deductible is less than the $5,450 maximum for family coverage, he would be allowed to deduct the full $2,400 if he had paid it. He cannot deduct the employer's pre-tax contribution, but he is allowed to deduct the additional $1,200 he contributes to the HSA. He will have the full benefit of the $2,400 and can use it as he needs to for qualified medical expenses without owing any tax. He must still file Form 8889 to record the contributions made by his employer and himself.

If Joe and Cathy file Schedule A (Form 1040), they can include the after-tax premiums they paid for the HDHP as medical expenses, but they will not be able to include any expenses paid from the HSA.

Question 3. What if Joe is a 50% owner of an S corporation, and the corporation makes the HSA contribution?

Answer 3. A more than 2% shareholder cannot exclude the employer contribution from income (Notice 2005-8, 2005-4 IRB 368), so the $1,200 should be included in box 1 of Joe's Form W-2, as well as in box 12. However, Joe then can treat the employer contribution as though he made it and deduct the entire $2,400 (employer and employee contributions) from his adjusted gross income. He must still file Form 8889.

The Current Situation

Consumer-driven health plans (CDHPs) are designed to give consumers more responsibility for health care costs, through the use of HDHPs accompanied by pre-tax health spending accounts such as HSAs and *health reimbursement arrangements* (HRAs). CDHPs are still a minority in the health care field. In October 2005 the first comprehensive survey of CDHPs was conducted by the Employee Benefit Research Institute (EBRI), an organization focused on employee benefit research and education. The survey found that only 1% of the U.S. adult population with private health insurance was covered by a CDHP. About 9% had an HDHP without an HSA or HRA, with the remainder having more comprehensive coverage that included health maintenance organizations (HMOs), preferred provider organizations (PPOs), and point of service (POS) plans.

However, a Kaiser Permanente vice president noted that half of that company's growth in 2005 came from CDHP products. In addition, America's Health Insurance Providers (AHIP), an association representing about 1,300 health insurance companies, found in a January 2006 member census that the number of individuals covered by HDHP/HSA plans grew from 438,000 in November 2004 to 3.2 million in December 2005. About 31% of the individual purchasers were previously uninsured, and 33% of the small business purchasers didn't previously offer any coverage.

An April 2006 report in the *Atlanta Journal Constitution* estimated the current balance in HSAs to total $2.3 billion.

Observation Presidential Participation

It is traditional for the U.S. President and Vice President to release their federal income tax returns each year. (The returns are accessible online at `www.taxhistory.org`.) The 2005 information shows that President and Mrs. Bush became HSA participants: Their return includes deductions for a contribution of $3,100 to the President's HSA and a contribution of $600 to Mrs. Bush's HSA. The Cheneys' return did not include an HSA deduction.

Cost Considerations

Cost and information issues predominate in discussions of the pros and cons of HSAs. The EBRI survey found that about one-third of people in CDHPs and HDHPs reported delaying or avoiding obtaining health care services, which was about twice the rate of those in comprehensive health plans (17%). The percentages were even higher in households with incomes of less than $50,000, where nearly half of the adults with an HDHP reported that they avoided or delayed obtaining health care because of costs, compared to about a quarter of those in the same income group who had comprehensive coverage. For this income group, paying a large annual deductible (as opposed to a copay of $10 or $30) before the insurance coverage kicks in is often prohibitive.

Insurance company statistics show that 89% of the U.S. population currently spends $2,000 or less on medical expenses each year, and 73% spend $500 or less. But those statistics are not comforting for an individual who doesn't have $2,000 to spend. If an HDHP is to be economically feasible, the insured needs to be able to fund the HSA portion.

On the other hand, some insurance is better than no insurance, and the amount of personal liability incurred by someone with an HDHP when there is a medical emergency is limited to the deductible and the out-of-pocket costs, rather than by the entire cost of the procedure. Affordability is a major selling point of HDHP plans. The AHIP report compiled the average figures shown in Figure 1.4 for the best-selling small group policies. Small group policies generally cover employers with 50 or fewer employees. Individual policy averages had similar deductibles and cost limits, but because premiums were age-based, for those under age 30 the premiums were less than half of the group policy averages.

FIGURE 1.4 AHIP Averages for HDHP/HSA Plans

Small Group Market	Single	Family
Annual Deductible*	$2,143	$4,311
Annual Out-of-Pocket Limit	$3,381	$6,575
Annual Premium	$2,772	$6,955

*Policies generally cover preventive care services before the deductible is reached.

Observation Emergency Room Cost

Emergency room costs can be very high. For example, a grandfather took his grandchild to a hospital emergency room in the midwest on a Saturday for treatment of a dog bite. The only treatment was application of an antibiotic salve to the wound. The bill was about $800, including a $95 supply charge.

Types of Treatment

Obtaining reimbursement of a claim through medical insurance frequently limits the types of treatment that are allowable, to the extent that it sometimes seems that the insurance company is directing the decisions made by medical personnel. While an HSA does not change that situation for expenses that will be paid by the HDHP, it can provide funding for complementary and alternative medical treatments, including acupuncture, homeopathy, traditional Chinese and Indian health care practices, or the services of a Christian Science healer. If preventive health procedures, such as vaccines, are not covered by the policy, they can be paid out of the HSA, as can maternity expenses not covered by the policy. Even over-the-counter medicines, such as aspirin and cough medicine, become allowable medical expenses.

Access to Information

The purpose of CDHPs is to give consumers more responsibility for making decisions about the health care costs they incur. But making informed decisions requires access to information about cost and quality. This is the biggest stumbling block between the ideal and the real world.

Surveys have shown that having an HSA tends to make the owner more cost conscious, more inclined to question the need for a particular treatment, and more likely to request generic drugs in lieu of more expensive brands. The problem is that information about costs is difficult to come by, and even when such information is available, it may not drive a decision.

Some costs vary widely by geographic location. HealthGrades, Inc., offers ratings and profiles of hospitals, nursing homes, and physicians on its Web site at `www.healthgrades.com`. In a March 20, 2006, press release, it reported that the average list price (the price paid by an uninsured patient) for delivery of a baby without complications is $6,700 in western states and $12,400 in northeastern states. The out-of-pocket cost paid by an insured patient for a defibrillator implant averaged $2,100 in the Northeast and $9,200 in the Midwest.

That kind of information presumably might convince a budget-conscious consumer to travel for a planned procedure. But in reality, a pregnant woman is likely to seek prenatal care close to home, and she may not be able to travel as the birth date approaches. Similarly, a heart patient will probably want to stay with his or her own cardiologist.

Unless adequate information is available, and making choices based on it is feasible, the HSA cannot work as well as it might as a measure to control health care costs on a national level.

Retirement Savings

One touted benefit of an HSA is the opportunity to use the money for retirement purposes after age 65. For this to work, a participant who has funded the plan must stay healthy enough that the money has a chance to grow. An HSA can be used just to make current medical expenses tax deductible without the limitations of the itemized deduction rules. In this case, the money goes in and comes right back out. People who are healthy, however, can fund an HSA and let the balance grow tax-deferred. At age 65, the owner can withdraw the money for any purpose. If the withdrawal is not for medical expenses, it is taxed just like an IRA withdrawal, but there is no penalty. There is no current requirement for minimum distributions beginning at age 70½. However, the tax treatment of an inherited account is not favorable (except for a surviving spouse).

Uninsured or Uninsurable?

Some previously uninsured individuals who could not afford higher-priced policies are seeking HDHPs as an alternative. But people who are unable to get insurance because of pre-existing health conditions cannot find relief through an HDHP; the insurability requirements do not change simply because the deductible payment is higher.

Five chronic disorders—diabetes, hypertension, heart disease, asthma, and mood disorders—account for almost half of U.S. medical expenses. When an individual seeks information about an HDHP, it is not unusual for the insurance company to specify one or more of these areas as a problem even before the application form is started. If the individual with one of these disorders is able to get an HDHP and fund an HSA, there is the potential to save some money via cost comparisons and education. However, these conditions can also require current medical expenditures that prevent accumulations of HSA funds.

When insurability is not a problem, but an employer does not offer any type of health insurance, leaving the employees on their own to secure coverage, an HDHP can provide less expensive protection against catastrophic bills. The high deductible must still be met for the lesser amounts.

Practitioner Note Opportunity for Self-Employed

For a self-employed person, an HDHP with an HSA can cover health care costs and be fully deductible for income tax purposes. The HSA contribution and the insurance premium can qualify separately for deduction from adjusted gross income. Neither deduction affects self-employment tax liability, however.

Questions and Answers

Question 1. If I have an HSA, how does my insurance company know that I have met my deductible?

Answer 1. Covered expenses are submitted to the insurance company even though they are not paid because the deductible amount has not been met. Although there is no insurance payout, the company records your payments toward the deductible. This can also give you the benefit of a lower cost if your plan has negotiated a lower price for members, such as through a PPO.

Question 2. What if I start an HSA and then get a job where nonqualifying health insurance is provided by the employer?

Answer 2. You will no longer qualify to make contributions to your HSA, but you can still use the amount in the account to pay for medical expenses not covered by your new plan. There is no time limit on using the money, so it can stay in your account and grow tax free until you need it.

Question 3. Who determines whether my expenses are qualified? Does the HSA administrator do that?

Answer 3. You are in charge of recordkeeping for your contributions and your distributions; therefore **it is up to you to keep the receipts**. In January, the HSA administrator will send you a Form 1099-SA showing your distributions for the year, and in May you will receive a Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, showing your contributions for the previous year. (Because you have until April 15 of the following year to make the contribution for the current year, Form 5498-SA cannot be issued until after that deadline.)

Practitioner Note What Is the "Average Cost"?

Almost half of all 2004 employee health care costs stemmed from just 4% of workers and their dependents, Watson Wyatt, a business consulting firm, reported in an April 24, 2006, news release. Those 4% incurred 49% of the total medical costs in any given organization because of their catastrophic or chronic diseases, resulting in an average health care cost exceeding $10,000 per individual. The healthiest group, 72% of participants, accounted for just 11% of health care spending, incurring average costs of under $1,500 per year, Watson Wyatt found. The remaining 24% in any group incurred 40% of the costs because of acute health episodes or having an early-stage chronic disease.

ISSUE 3: PRESCRIPTION DRUGS

This issue addresses the tax consequences of two current prescription drug issues: importing medications from other countries and Medicare Part D coverage.

Importing Medicines

U.S. consumers pay 30% to 300% more for their prescription drugs than consumers pay in other countries, Sen. Chuck Grassley, R-IA, reported in a 2004 legislative proposal. Because of foreign government–imposed cost controls, prices for many prescription medicines are substantially lower in other countries than they are in the United States. Many individuals with chronic conditions, after comparison shopping via the Internet, are saving money by ordering medicines from Canada or from another country where prices are lower.

But there are at least two separate areas of concern beyond the stated price: the legality and safety of the medications, and the tax effect.

Safety Issues

Importing most prescription drugs is a violation of federal law and of some state laws regarding pharmacy regulation and licensing, and foreign drugs may not meet U.S. Food and Drug Administration (FDA) standards. FDA Publication 04-1511A, *Looks Can Be Deceiving,* highlights several risks taken by those who buy foreign medicine from an Internet site, from a storefront business that offers to order medicine from abroad, or during visits outside the United States.

- Quality assurance: Medicines that have not been approved for sale in the United States may not have been manufactured under quality assurance procedures designed to produce a safe and effective product.
- Counterfeit potential: Some imported medicines—even those that bear the name of a U.S.-approved product—may be counterfeit versions that are unsafe or ineffective.
- Untested substances: Some imported medicines and their ingredients, although legal in foreign countries, may not have been evaluated for safety and effectiveness in the United States. These products may be addictive or contain other dangerous substances.
- Unsupervised use: Some medicines, whether imported or not, are unsafe when taken without adequate medical supervision. A medical evaluation may be needed to ensure that the medicine is appropriate for the consumer, or to make sure that it is being taken properly, that it is working, and that there are no unexpected or life-threatening side effects.
- Labeling and language issues: The medicine's label, including instructions for use and possible side effects, may be in a language the consumer does not understand, or it may make medical claims or suggest specific uses that have not been adequately evaluated for safety and effectiveness.
- Lack of information: An imported medicine may lack information that would permit the consumer to be promptly and correctly treated for a dangerous side effect caused by the medicine.

Practitioner Note Different Versions of Drugs

The FDA notes that drugs made in the United States for foreign markets frequently are not manufactured by a firm that has FDA approval for that drug. Even if the manufacturer has FDA approval for a drug, the version produced for foreign markets often does not meet all of the requirements of the U.S. approval. Foreign versions of the drugs are often what Canadian pharmacies offer to sell to U.S. consumers.

Tax Deduction Issue

The cost of prescription drugs is normally an allowable income tax deduction. But there is a tax trap if the prescription is ordered from another country.

Treas. Reg. §1.213-1(e)(2) states that the term *medicine and drugs* includes only items that are legally procured. Amounts expended for items that are excluded from the term *medicine and drugs* are not considered amounts expended for medical care. IRS Publication 502, Medical and Dental Expenses, is very clear: "In general you cannot include in your medical expenses the cost of a prescribed drug brought in (or ordered shipped) from another country, because you can only include the cost of a drug that was imported legally."

Even if a prescription drug is approved in the United States and was originally manufactured here, it is a violation of the Food, Drug, and Cosmetic Act for anyone other than the original U.S. manufacturer to import the drug into the United States [21 U.S.C. §381(d)(1)]. An FDA statement of position on foreign drug imports clarifies that, although the agency's "personal importation policy" sometimes allows consumers to import illegal drugs, the drugs are still illegal. The policy simply describes the FDA's enforcement priorities–it does not change the law.

Practitioner Note FDA Personal Importation Policy

FDA personnel may use their discretion when illegal items being brought into the United States are clearly for personal use **and** the product does not present an unreasonable risk to the user. Individuals of differing ethnic backgrounds sometimes prefer products from their homeland or products labeled in their native language to products available in the United States. Other individuals seek medical treatments that are not available in the United States. A patient importing this type of product must provide the name of a licensed physician in the United States who is responsible for the patient's treatment with the unapproved drug.

What if a state or local government has approved the importation? A state law or local ordinance allowing prescription drugs to be imported from other countries does not change the fact that federal law does not permit it. This stance is confirmed by a 1997 revenue ruling holding that the purchase of a controlled substance for medical use, in violation of federal law but permitted under state law, is not a legally procured medicine or drug within the meaning of Treas. Reg. §1.213-1(e)(2), so that the cost isn't deductible as a medical expense (Rev. Rul. 97-9, 1997-1 C.B. 77).

However, if a consumer legally obtains and uses a prescription drug while in a foreign country, the cost may qualify as a medical expense. The prescribed drug must be purchased and consumed in the other country **and** be legal in both countries.

Medicare Benefits

As of January 1, 2006, prescription drug coverage (Part D) was added to the health care benefits available through Medicare. Most beneficiaries previously were enrolled in Part A, hospital insurance, and Part B, medical insurance.

Most people get Part A, hospital insurance, automatically when they turn age 65. Part A helps cover inpatient care in hospitals, hospices, and skilled nursing facilities, and it also provides some home health care. Some deductibles apply. The benefits are funded primarily through the Medicare payroll tax (1.45% each for employee and employer, 2.9% for self-employed individuals). Thus, most beneficiaries don't pay a specific premium for Part A because they (or their spouses) paid the tax while they were working. However, an individual who is otherwise eligible to participate in Medicare, but who did not earn enough work credits to qualify for it, can enroll in Part A Medicare hospital insurance by paying a monthly premium ($393 per month in 2006). This premium is eligible to be deducted as health insurance on Schedule A (Form 1040).

Participation in Part B, medical insurance, requires all participants to pay an additional premium that is generally deducted from the participant's social security benefit check. Part B helps cover doctors' services and outpatient care, including some physical and occupational therapy, screening services and flu shots, and an additional amount of home health care service. A $124 deductible must be paid before Part B begins to pay its share, and copays often apply. In 2006, the basic Part B monthly premium is $88.50. However, an individual who did not sign up for Part B when he or she first became eligible (generally at age 65, regardless of full retirement age) is charged an additional 10% premium for each 12-month period that enrollment was delayed. This penalty continues to apply throughout the Part B coverage. The premium cost for Part B is also deductible as health insurance on Schedule A (Form 1040).

Planning Pointer Group Coverage Exception if Not Retired

If an individual or spouse is still working when the individual becomes eligible for Part B coverage, an exception to the premium penalty may apply. Individuals who are covered by an employer or union group health plan because of current or active employment may delay Part B enrollment without penalty. A special enrollment period applies for eight months following the month the group health plan coverage ends or the employment ends (whichever is first).

Part C is the Medicare Advantage program, established under the Medicare Modernization Act of 2003 (Pub. L. No. 108-173), which replaced the Medicare+Choice program. Medicare beneficiaries who are covered by both Part A and Part B may elect either the original Medicare fee-for-service program or a Medicare Advantage plan. These plans (which include HMOs and PPOs) may cover more services and have lower out-of-pocket costs, but the participants' choices of doctors and hospitals may be limited.

Many Medicare beneficiaries opt for private Medigap policies to help cover out-of-pocket costs such as coinsurance, copayments, and deductibles. Before 2006, prescription drugs often were covered by these policies. But Medicare Part D generally has replaced the Medigap policy coverage of prescription drugs. Medicare Part B will still cover certain drugs, like some cancer drugs, that are usually administered or given out in a doctor's office.

Part D

Medicare prescription drug coverage is offered in two ways. Some Medicare Advantage plans incorporate all Medicare benefits, including Part D, into one plan. Participants in original Medicare or an Advantage plan that doesn't include prescription drug coverage can enroll in separate Part D coverage. Enrollment is optional, but to get the lowest rates, enrollment in Part D was required by May 15, 2006, for current Medicare beneficiaries. Late enrollees are charged a permanent premium increase of 1% of the base beneficiary premium per month of delayed coverage.

An open enrollment period for electing coverage or changing plans will be available from November 15 to December 31 of each year, with coverage beginning January 1 of the following year. The initial enrollment period for individuals who are first eligible for Part D coverage after January 31, 2006, generally is a seven-month period that is the same as their enrollment period for Part B coverage (beginning three months before the month an individual first meets the eligibility requirements and ending three months after the first month of eligibility). Coverage begins the later of the month of eligibility (for early enrollment) or the month following enrollment.

Planning Pointer Exception for Equivalent Coverage

Medicare beneficiaries who are already covered by an employer or union health plan with prescription drug coverage that is certified to be at least as good as the Medicare standard plan may keep that coverage as long as it is still offered by the employer or union. If the employer or union stops offering prescription drug coverage, the participants can join a Medicare drug plan within 63 days after their former coverage ends without being subject to the late enrollment penalty.

In most geographic areas, there are literally dozens of Part D plans available, and they vary widely in premium costs, the medications they cover, and the charges for those drugs. Each plan covers prescription drugs under its own formulary (a list of covered drugs). Medicare has established a list of drugs, but not all plans cover all of the listed drugs. The following points apply to Part D programs:

- Drug plans don't have to cover every drug that's included in the Medicare list. They only have to cover every *type* of drug. Some plans cover fewer than 800 drugs; others cover more than 1,800.

- If a prescribed drug is not on the plan's formulary, the patient and doctor can change to a different drug, or they can ask the plan for an exception so that it will be covered.
- If a specific medicine is not covered by the plan, and it is prescribed anyway, the patient must pay the entire cost, without credit towards the deductible or copays.
- Plans may cover both generic and brand-name prescription drugs. All covered drugs must be approved by the FDA as safe and effective.
- An insurer can remove a drug from its formulary, increase co-payments, or impose new restrictions only if enrollees currently taking the affected drug are exempt from the change for the remainder of the plan year.

When choosing a plan, participants also need to check the pharmacies that are connected with each plan. People who travel frequently for extended periods, such as winter snowbirds, may need to select a plan that is available nationwide, not one that offers only regional coverage. Some plans include mail-order pharmacy options.

Consumer Costs

Medicare estimates that Part D prescription drug coverage typically pays for about half of an enrollee's drug costs. The amount actually paid varies depending upon the plan that is chosen. The Part D premium is estimated to average about $32 per month for most people. In addition to paying the premium, each person has to pay the first $250 of prescription drug costs each year (the deductible). After the deductible is met, the Part D plan pays 75% of the next $2,000 in costs. The next $2,850 is paid entirely by the policyholder, until the out-of-pocket cost (not including the plan premium) reaches $3,600 ($250 + $500 + $2,850). After that, beneficiaries pay the greater of $2 for generic drugs (and some plan-preferred drugs), $5 for nonpreferred drugs, or 5% of the drug's cost. There is no limit on the amount of drugs that can be covered. A plan may reduce the copay for generic or preferred drugs to zero.

Three levels of extra subsidies are available for those with both limited income and limited financial resources. Home ownership is not counted.

1. For 2006, an individual with annual income below $12,920 ($17,321 for a married couple living together), with financial resources not exceeding $7,500 ($12,000 for a married couple living together), is not required to pay a premium or deductible. Copays cannot exceed $2 for a generic drug and $5 for other drugs.
2. At the same income levels, but with higher financial resources (up to $11,500 for an individual or $23,000 for a married couple living together), the participant pays no premium, a $50 deductible, and a copay of not more than 15% of the medicine's cost.
3. If income is slightly higher (from $12,920 to $14,355 for an individual and from $17,321 to $19,245 for a married couple living together) and resources aren't more than the $11,500 level ($23,000 for a married couple living together), there is a discounted premium, a $50 deductible, and the 15% limit on copays.

Example 1.5 Part D Out-of-Pocket Costs

Margaret, who does not qualify for an extra subsidy, opted for Part D prescription drug coverage beginning January 1, 2006. Her premium is $32 a month ($384 for the year), and her total 2006 prescription drug cost is $3,200. She had a similar prescription drug expense in 2005 without any insurance coverage.

Question 1. How much will she save with Part D?

Answer 1. $1,116, as shown in Figure 1.5. She will pay $1,700 for her medicines plus $384 for the Part D premiums (a total of $2,084).

FIGURE 1.5 Savings Calculation

Prescription Drug Costs		**$3,200**
Margaret's costs		
Premium	384	
Deductible	250	
25% of $2,000	500	
100% of excess over $2,250	950	
Subtotal of costs		2,084
Savings		**$1,116**

Question 2. What can Margaret include on her Schedule A (Form 1040) if she can itemize medical expenses?

Answer 2. The $384 premium cost plus her $1,700 out-of-pocket costs, or $2,084. She can also deduct the $88.50 monthly premium for Part B ($1,062 for the full 12 months), bringing the total to $3,146.

Practitioner Note Costs Vary Widely

Although the deductible and copay percentage amounts are the same for all approved Part D plans, the bottom line to the participant can be quite different, both because of premium differences and because of discounts various insurers may have negotiated with pharmacies and manufacturers. For example, one Indiana participant had a choice of 62 plans, with estimated annual costs ranging from $686 to $2,268 for the same three medications. About half (33) of those plans included all of her medicines in their formularies. The monthly price for one medicine (Vytorin) ranged from less than $20 to more than $90. Policy premiums ranged from $12.30 a month to $70.72 a month.

Questions and Answers

Question 1. I didn't sign up for Part D because I am covered under a plan by my previous employer. It was certified as being "creditable prescription drug coverage." Now that the deadline to sign up is past, my previous employer has announced that the company is dropping the drug coverage. How much is this going to cost me?

Answer 1. You don't have a problem as long as you sign up for Part D within 63 days after the coverage actually ends. Because you were covered by a plan that met the Medicare standards, the penalty does not apply to you.

Question 2. Could you give some examples of plans that are considered to be creditable prescription drug coverage?

Answer 2. Veterans' Affairs (VA), military retiree benefits (TRICARE), and the Federal Employer Health Benefits Program (FEHB) are among the plans offering equivalent coverage. Employer and union plans are required to provide a letter to their participants, explaining whether the coverage is equivalent.

Question 3. If I am self-employed, over age 65, and paying for Part B and/or Part D Medicare benefits, can I qualify for the self-employed health insurance deduction, based upon my Medicare health insurance premiums?

Answer 3. An IRS chief counsel advice memorandum (CCA 200524001) states that a health insurance policy purchased by a sole proprietor does not have to be issued in the name of the trade or business to qualify for the deduction. However, the deduction must be claimed for a specific plan established under a specific trade or business, so it must be identified with a particular business.

Question 4. Help me to understand the penalty if I didn't sign up by May 15, but I want to sign up during the next opportunity beginning November 15.

Answer 4. The base beneficiary premium for 2006 is $32.20 per month. If you enroll November 15, your coverage will begin in January. Because you were not enrolled by May 15, when your coverage would have begun June 1, you will be charged an extra 1% of the base premium per month, or 7%, because your coverage will begin seven months late. $32.20 times 7% equals $2.25, so your monthly payment will be $2.25 higher than your selected plan's stated monthly premium. The additional 7% will be added to your premium cost as long as you are part of the program. However, if you qualify for the low-income subsidy, you can sign up at any time without a penalty.

Question 5. But why is there a penalty?

Answer 5. All insurance works through spreading risk. Health insurance plans need some healthy people who are paying the premium but costing the plan less in current benefits than a less-healthy person. This keeps premiums more affordable. The Part D penalty is designed to encourage participation during those earlier and possibly healthier years.

Planning Pointer Part B Premiums

To help fund the Medicare program, Part B premiums will vary in 2007 based on the participant's 2005 income [42 U.S.C. §1395r(i)]. Whether the individual has Part D coverage is not a factor. Currently, all Part B participants pay a premium that is calculated at 25% of the projected cost for aged participants. Beginning in 2007, higher-income participants will receive a smaller government subsidy of the Part B premium. The 2007 premiums based on modified adjusted gross income (MAGI) are as follows:

Single	Joint Return	Surcharge	Premium
Up to $80,000	Up to $160,000	none	$93.50
$80,000–$100,000	$160,000–$200,000	$12.50	$106.00
$100,001–$150,000	$200,001–$300,000	$31.20	$124.70
$150,001–$200,000	$300,001–$400,000	$49.90	$143.40
Over $200,000	Over $400,000	$68.60	$162.10

MAGI adds tax-exempt interest, the interest exclusion for U.S. savings bonds used for educational expenses, and excluded foreign-earned income and possessions income to AGI.

The subsidy reduction is being phased in over 3 years, one-third in each of the years 2007, 2008, and 2009. At that point, the highest income group will be paying 85% of the projected cost, with the government subsidy reduced to 15%. The income levels for each year will be based on the second prior year, and they will be indexed to inflation.

Medicare beneficiaries affected for 2007 will be notified by letters mailed in November 2006. Individuals with life-changing events that have significantly decreased their income compared to the earlier year may appeal the higher premium. Medicare officials said they expect 9,000 people to drop the program in 2007 because of the new income-based premiums and 30,000 to leave before 2010. The income-based premiums are expected to save Medicare $7.7 billion over 5 years and more than $20 billion over 10 years.

ISSUE 4: RESIDENCY FOR INCOME TAX PURPOSES

This issue points out the differences between standards for determining residency for citizenship and immigration purposes and for federal income tax purposes. Many nonimmigrants are taxed just like U.S. citizens.

Legal Permanent Resident

An alien is anyone who is not a U.S. citizen, whether or not the person's presence in the U.S. is legal. Becoming a legal permanent resident alien of the United States is an involved process under immigration rules. Becoming a legal permanent resident is required before an alien can apply for naturalization as a U.S. citizen, and there are many bridges to be crossed en route to receiving a permanent alien registration card (often referred to as a green card). The application itself and required documentation require substantial effort for accurate completion, and the information presented is thoroughly examined by U.S. immigration authorities.

There are several routes to green card status, including sponsorship by a family member, sponsorship by an employer, investment of at least $1,000,000 in a new commercial enterprise ($500,000 for investment in a "targeted employment area"), holding asylee or refugee status for a year, international adoption, and special programs for specific countries of origin. Generally, there is an overall limit of 675,000 permanent resident visas that can be issued each year, and no more than 7% can be from a single country, although some immigrant categories are exempt from the numerical limitations. Application information and forms are available on the U.S. Citizenship and Immigration Services Web site at `www.uscis.gov`.

Some individuals qualify for an additional chance at immigration. In 1990, an annual "Diversity Lottery" administered by the U.S. Department of State was established. This lottery makes 50,000 permanent resident visas available each year to persons from countries with low rates of immigration to the United States under the other programs. No visas go to citizens of countries that have sent more than 50,000 immigrants to the U.S. in the prior five years, and within each of six geographic regions, no one country may receive more than 7% of the diversity visas in any one year. Applications must be submitted on-line at `www.dvlottery.state.gov`.

Residency under Tax Law

For immigration purposes, citizens of other countries who do not have green cards are always nonresidents. But an extended physical presence in the U.S. often is enough for the IRS to tax the individual as a U.S. resident. Aliens who are present in the U.S. illegally are often treated as resident aliens for federal income tax purposes.

Identifying whether someone is a resident or a nonresident is one of the most confusing areas in U.S. taxation. Classification as a resident alien or a nonresident alien determines which U.S. tax return is to be filed. The U.S. taxes its citizens and residents on worldwide income; nonresidents are taxed only on U.S.-source income. Resident aliens file the same forms as U.S. citizens; nonresident aliens must file special nonresident forms, with more limited deductions and credits.

The first step, then, is to define terms:

- **Alien:** Anyone who is not a U.S. citizen
- **Resident alien:** Any alien who meets a tax law residency test
- **Nonresident alien:** Any alien who does not meet a tax law residency test

Tax Residency Tests

Under tax law, a person is considered a resident if he or she meets either of the following two tests:

1. The green card test.
2. The substantial presence test.

An alien who has a green card is also a resident for tax purposes from the first day he or she is present in the U.S. with permanent resident immigration status. The first year may be a dual-status year, as explained later in this issue.

The substantial presence test, which is somewhat cumbersome, is a mathematical calculation that applies to individuals who are present with nonimmigrant visas or without any visa. It is based on the number of days the individual is physically present in the United States during a 3-year period. The minimum requirement is a presence of at least 31 days in the current tax year and of at least 183 days in the total 3-year period. The catch is that only 1/3 of the days count in the first prior year, and only 1/6 of the days count in the second prior year. Partial days are not rounded up; they are dropped from the final total (for example, 182 2/3 days becomes 182 days).

Some days are not counted for the substantial presence test. They include days of regular commuting between Canada or Mexico, a presence of less than 24 hours when in transit between two places outside the United States, days of service as a crew member of a foreign vessel, days the alien is unable to leave the United States because of a medical condition that arose after entry, and days the alien is present on an exempt visa. The exempt visa categories are A and G (foreign government or international organization) and, for limited periods of time, F, J, Q, and M (teachers or students). In addition, days of presence are not counted for a professional athlete (P-1 visa) present for a charitable sport event.

Observation U.S.-Source Income Still Taxable

Individuals in the above categories are not exempt from U.S. income taxation. They merely are exempt from counting those days of presence for the residency test. Thus, they usually are taxed as nonresident aliens.

Example 1.6 Substantial Presence

Irene was physically present in the United States for 120 days each in 2004, 2005, and 2006 on a visitor's visa. She counts the full 120 days in 2006, 1/3 of 120 (40) in 2005, and 1/6 of 120 (20) in 2004, for a total of 180. Because this is less than

183, she does not qualify as a resident alien in 2006. If she has any reportable U.S.-source income, Irene must file a U.S. tax return as a nonresident alien. If she is not eligible for a U.S. social security number, she must obtain an Individual Tax Identification Number (ITIN), as explained later in this issue, for filing the return.

Social Security Numbers

All aliens who can be legally employed in the United States are eligible for social security numbers, regardless of their immigration or tax residency status. It is possible to be a nonresident alien and have a social security number. Figure 1.6 lists visa classifications that generally allow the holder to receive a social security number. These aliens can be either residents or nonresidents for tax purposes under the substantial presence test.

FIGURE 1.6 Work-Eligible Visas

Visa Classification	Definition
E-1, E-2	Treaty trader or treaty investor
F-1	Foreign academic student, when certain conditions are met
H-1B, H-1C, H-2A, H-2B, H-3	Temporary worker
I	Foreign information media representative
J-1	Exchange visitor, when certain conditions are met
K-1	Fiancé of a U.S. citizen
L-1	Intra-company transferee
M-1	Foreign vocational student
O-1, O-2	Temporary worker in the sciences, arts, education, business, or athletics
P-1, P-2, P-3	Temporary worker in the arts, athletics in an exchange or cultural program
Q-1, Q-2	Cultural exchange visitor
R-1	Temporary religious worker with a nonprofit organization
TN	Professional business worker admitted under NAFTA

Foreign-Born Spouse

The green card and substantial presence tests apply to the foreign-born spouse of a U.S. citizen just as they do to other aliens. If the spouse meets a residency test, the U.S. tax return rules are the same as for any other married couple. The couple can choose to file separately or married filing jointly, taking advantage of all of the available credits and deductions. All worldwide income must be reported on their returns.

A married couple may elect to file a joint return even if one of them is a nonresident alien. If this choice is made, both spouses are treated for income tax purposes as U.S. residents for the entire tax year, and they are taxed on their worldwide income. Neither can claim not to be a U.S. resident under a tax treaty. The couple must file a joint income tax return for the year they make the choice, but they can file joint or separate U.S. resident returns in later years.

The election is made by attaching a statement, signed by both spouses, to the first joint return. The statement must declare that one spouse was a nonresident alien and the other spouse a U.S. citizen or resident alien on the last day of the tax year, and that they are choosing to be treated as U.S. residents for the entire tax year. It must include the name, address, and identification number of each spouse. The election can be made on an amended return for an open tax year.

Either spouse can revoke the choice for any tax year, provided he or she makes the revocation by the due date for filing the tax return for that tax year. The spouse who revokes the choice must attach a signed statement declaring that the choice is being revoked.

Practitioner Note Nonresident Alien Spouse

A married U.S. citizen or U.S. resident alien is considered unmarried for head of household filing status purposes if the spouse is a nonresident alien, and the couple does not choose to treat the nonresident spouse as a resident alien. However, all of the usual tests to be head of household must be met, and the nonresident spouse is not a qualifying person: The U.S. citizen or resident alien must provide a home for another qualifying person. If the head of household criteria are not met, a married U.S. citizen or resident alien who is not filing a joint return must file as married filing separately.

Applying for an ITIN

If the spouse does not have a green card and has not been admitted to the U.S. on a qualifying visa, he or she may not be eligible for a social security number. In this case, the IRS issues an Individual Taxpayer Identification Number (ITIN) to be used for tax reporting only. An ITIN does not permit a person to be employed in the United States, and if either the husband or the wife has an ITIN, they cannot qualify for the work-based earned income credit.

Because the ITIN is issued solely for tax reporting purposes, the applicant must show there is a federal tax reason for obtaining the number. In most cases, Form W-7, Application for Individual Taxpayer Identification Number, must be attached to the front of a completed original federal income tax return. (The applicant can be either the taxpayer or a dependent on the return.) If the ITIN is not needed for filing a tax return, it will not be issued unless an exception applies. Exceptions that allow assignment of an ITIN before a return is filed include the alien's ownership of an asset that generates income subject to information reporting, third-party withholding requirements, and a requirement to obtain a tax number for treaty benefits.

Proof of both identity and foreign status must be included with Form W-7. The IRS will accept an unexpired passport (original, legally notarized or certified) as proof of both identity and foreign status. Lacking that, two or more of the following documents (originals or legally notarized copies) will be accepted: national identification card, U.S. driver's license, civil birth certificate, foreign driver's license, U.S. state identification card, foreign voter's registration card, U.S. military identification card, foreign military identification card, U.S. visa, or USCIS photo identification. For dependents, medical and school records may be accepted. The documents must be current, and at least one must include a photograph. If the application is for a taxpayer's spouse or dependent, the documentation should show the relationship.

Regardless of where the taxpayer would normally file, a return with an attached Form W-7 and documentation should be sent to

Internal Revenue Service
Philadelphia Service Center
ITIN Unit, P.O. Box 447
Bensalem, PA 19020

Alternatively, it may be submitted at an IRS Taxpayer Assistance Center for mailing to the ITIN processing unit. Some IRS offices are able to review the documentation, notate the Form W-7, and return the documentation to the applicant. If original documents are mailed, the ITIN unit returns them by mail after assigning the ITIN. Copies are not returned.

Practitioner Note ITIN Provided in Letter

The IRS no longer issues ITIN cards because an ITIN is not to be used for identification. Instead the applicant will receive an authorization letter. It normally takes 4 to 6 weeks to receive the letter after submitting the ITIN application. ITINs are nine-digit numbers formatted like social security numbers. They always begin with the number 9, and the fourth digit is either a 7 or an 8.

Example 1.7 Federal Tax Requirements

Chuck married Felicia on October 31, 2006, in Indiana, after a whirlwind romance. Chuck has $32,000 of Form W-2 income. Felicia had earnings in Mexico equivalent to $2,500 in U.S. currency before she entered the U.S. for the first time in August. They have begun the process for Felicia to obtain permanent residency, but there are several steps to be completed before she is eligible for a social security number. Because they are anticipating a good-sized refund, they would like to file a joint return as soon as possible.

Question 1. Can they file a joint return?

Answer 1. Yes. They can prepare the return and send it, along with Form W-7 and the required documentation (proof of their marriage and of Felicia's foreign status and identity). Felicia will then receive an ITIN to use for tax purposes until she receives her social security number.

Question 2. What about the $2,500 in Mexican income?

Answer 2. It must be reported on the joint return.

Question 3. What happens to the ITIN when Felicia gets her SSN?

Answer 3. The SSN takes priority. Felicia should notify the IRS, which will merge the information. Please note that Felicia won't be eligible to work in the United States until she gets her SSN.

Question 4. Did Felicia meet the substantial presence test?

Answer 4. No, but the couple can make the nonresident spouse election described previously in this issue.

Practitioner Note Acceptance Agents

Tax preparers, as well as other individuals and entities, can apply to the IRS for authorization to assist aliens in obtaining ITINs. Applicants must submit to suitability checks. An *acceptance agent* forwards a completed Form W-7 and the required documentation to the IRS for processing. A *certifying acceptance agent* reviews the Form W-7 and documentation, completes a certificate of accuracy, and sends the certificate and application (without the documentation) to the IRS for processing. Prior-year acceptance agent agreements will expire on December 31, 2006, and existing agents are required to reapply during 2006 on Form 13551, Application to Participate in the IRS Acceptance Agent Program, to retain their status. In the future, agreements must be renewed every fourth year. Agents may request inclusion of their contact information on a list published by the IRS. Rev. Proc. 2006-10, 2006-2 IRB 293, provides guidance on the application process.

Form 1040NR

Form 1040NR has some similarities to Form 1040, but there are also some differences of which the tax practitioner should be cognizant. Form 1040NR must be filed in four situations:

1. A nonresident alien is engaged in a trade or business in the United States, even if there is no U.S. income from the business, or the business income is exempt from U.S. tax (such as under a tax treaty). For purposes of this situation, being an employee is treated as being in a trade or business.
2. A nonresident alien has U.S.-source interest, dividends, rental income, pension income, or social security benefits (85% taxable), *and* an insufficient amount of tax was withheld from these payments.
3. A nonresident return is required for a decedent (the representative must file the return).
4. A nonresident estate or trust has U.S.-source income (the representative must file Form 1040NR, adjusting it to reflect the provisions of Subchapter J).

Practitioner Note Exception for Some Wage Earners

Under an exception to the first requirement, a nonresident alien with wage income is not required to file a U.S. return if the wage income does not exceed the personal exemption amount ($3,300 for an individual in 2006), and any required amount of tax is withheld on other (nonwage) income (Notice 2005-77, 2005-46 IRB 951).

Most nonresident aliens may not claim exemption deductions for a spouse or dependents. Exceptions apply to U.S. nationals (residents of American Samoa or the Northern Mariana Islands who chose to be U.S. nationals) and residents of Canada, Mexico, and the Republic of Korea. Generally, these individuals may claim dependents under the same rules (including the residency test) that apply to U.S. citizens. The treaty with the Republic of Korea (South Korea) limits the deduction to dependents who lived in the United States with the taxpayer for at least part of the tax year.

Law Change Treaty with Japan

In 2005 and earlier years, the tax treaty with Japan allowed deductions for dependents. However, a new treaty that took effect in 2005 eliminated this deduction. Taxpayers could elect to apply the old treaty for the 2005 tax return, but that option is not available for 2006 returns.

A nonresident alien's U.S.-source income is divided into the following three categories:

1. **Effectively connected income** (income connected to a U.S. trade or business), which is reported on page 1 of Form 1040NR, reduced by limited adjustments to income and deductions, and taxed at the same graduated rates that apply to U.S. citizens
2. **Not effectively connected income** (income not connected to a U.S. trade or business), which is reported on page 4 of Form 1040NR and is generally taxed at a flat 30% rate (unless a lower rate is provided in a treaty)
3. **Income exempt from U.S. tax** under the Internal Revenue Code or under a tax treaty, which is reported on page 5 of Form 1040NR

Page 2 of Form 1040NR allows some credits to be used against the tax imposed on effectively connected income. Credits cannot be used to reduce the tax imposed on the investment and other income that is taxed at a flat rate.

A standard deduction is not allowed on Form 1040NR (unless there is a treaty benefit specifically allowing it), and permitted itemized deductions (page 3) are limited. Only state and local income taxes, contributions to U.S. charities, casualty and theft losses, employee business expenses, and miscellaneous itemized deductions are allowed.

Page 5 of Form 1040NR requires knowledge of the type of visa issued to the nonresident alien, as well as of any applicable tax treaties. The starting point for more information about treaties is IRS Publication 901, U.S. Tax Treaties. The treaties are accessible on the IRS Web site.

A simplified filing procedure applies if there is no U.S. trade or business income, and the only reason for filing is to claim a refund of withheld tax. Pages 1 and 3, and most lines on page 2, are not completed (except for the entity information on page 1).

Questions and Answers

Question 1. What is a dual-status resident?

Answer 1. Dual-status occurs when a person changes from nonresident to resident tax status or vice versa within a single tax year, most often in the year of arrival or departure. The return to be filed depends upon residency status on the last day of the year: If a former resident has become a nonresident, Form 1040NR is filed, and if the year-end status is that of a resident, Form 1040 is filed. In either case, the other form must also be filed, but it is used as an attachment to identify income allocated to the former status. The term "dual-status return" should be written across the top of the primary form, and the term "dual-status statement" should be written across the top of the attachment. Restrictions that apply to a dual-status return include bans on use of a standard deduction, on head of household filing status, and on married filing jointly filing status.

Question 2. What if a U.S. citizen who has a nonresident alien spouse already filed as MFS because the spouse has no U.S. income and no identification number, and the taxpayer would have benefited from a joint return?

Answer 2. You can amend the return. Prepare Form 1040X, Amended U.S. Individual Income Tax Return, and include the Form W-7 and documentation for the ITIN applicant. Submit it to the ITIN unit at the Philadelphia Service Center. The amended return could change to a joint filing status, or it could just claim an exemption deduction for a spouse with no U.S. income. If the change is to a joint return, the spouse's worldwide income must be reported (after translation to U.S. dollars).

Question 3. Is an illegal alien required to file a tax return and report income?

Answer 3. An illegal alien is subject to the same income tax rules as an alien whose presence in the U.S. is legal. The substantial presence test determines whether an illegal alien is taxed as a resident or a nonresident alien.

ISSUE 5: LIFE ESTATES

The effect of a *life estate* is relatively simple—it just entitles the holder to use or receive income from a specified property during the life of the holder or of another person. Unfortunately, merely understanding what a life estate is does not answer the tax questions that arise when the life estate holder dies or wants to sell the interest. This section focuses on the basis and other tax rules for life estates that are inherited or are created by a decedent's will.

Basis of Life Estate

At the time of inheritance, property has a basis equal to its estate tax valuation (I.R.C. §1014). Under current law, this is its fair market value at the date of death, unless a federal estate tax return is required to be filed, and the alternate valuation date is elected, or special-use valuation is elected.

If more than one person inherits a time-related interest (life estate, term of years, or remainder) in the same asset, Treas. Reg. §1.1014-4 provides that the basis of the property is "uniform in the hands of every person having possession or enjoyment of the property **at any time** [*emphasis added*] under the will or other instrument or under the laws of descent and distribution." This means that, regardless of when a taxpayer actually obtains use of the inherited property, the basis relates back to the value on the original transferor's date of death. A similar uniform basis rule applies to term interests acquired by gift [Treas. Reg. §1.1015-1(b)].

The uniform basis rule has several tax ramifications. If the property is depreciable, the life estate holder calculates depreciation on the full basis. If the entire property is sold or gifted, a portion of the basis of the full property is allocated to each partial interest. Basis might also need to be apportioned for a casualty loss deduction, depending on the terms of the life estate.

Dividing the basis between the life tenant (the person who has only lifetime use of the asset) and the remainder person (the person to whom it will ultimately belong) requires calculating the present value of the partial interest. Treas. Reg. §20.2031-7(d) provides that an actuarial factor that is based on a combination of the life estate holder's age and an interest rate issued monthly under I.R.C. §7520 is used to make the allocation. The IRS lists the actuarial factors in Publication 1457, Actuarial Values–Book Aleph (868 pages). The interest rate is 120% of the applicable federal midterm rate, compounded annually, rounded to the nearest two-tenths of one percent, for the month of valuation. These rates are shown in Chapter 17, Tax Rates and Useful Tables, in this book.

Practitioner Note Casualty Loss Allocation

In *Steinert v. Commissioner,* 33 TC 447 (1959), the life tenant was allowed to deduct only part of the total casualty loss. In *Bliss v. Commissioner,* 256 F.2d 533 (CA-2, 1958), rev'g and rem'g 27 TC 770 (1957), the court allowed the life estate holder to deduct the entire casualty loss from a hurricane. However, the court also stated, "We wish to be understood, however, as not formulating any rule of general application but only as deciding this case on the basis of the unusual fact situation now before us."

Example 1.8 Basis Division

Bart died and left a life estate in his family home to his second wife, Lucille. When she dies, Donny (Bart's son from his first marriage) will get the house. Lucille's 48th birthday was the week after Bart's death, and the house was valued in his estate at $500,000. The applicable I.R.C. §7520 rate for the month of Bart's death was 5.8%.

Question 1. Lucille wants a condo rather than Bart's family home, and Donny is settled in another state. If Lucille and Donny agree to sell the property right away, what portion of the basis belongs to her?

Answer 1. The life estate factor at a 5.8% interest rate for age 48 is 0.77540, per Table S (5.8) in Publication 1457, which is shown as Figure 1.7. Lucille's basis, then, is $387,700 ($500,000 x 0.77540).

Question 2. What is Donny's basis for disposition of his interest?

Answer 2. The $112,300 ($500,000 – $387,700) remainder of the basis belongs to Donny.

Question 3. Does the total basis change over the period of the life estate?

Answer 3. In the absence of improvements or tax-deductible losses, the total basis does not change—just its allocation between Lucille and Donny. The portion assigned to each person does change because the value of a life estate decreases over time [Treas. Reg. §§1.1014-5(a)(2) and 1.1015-1(b)]. In addition, the usual basis adjustment rules apply (I.R.C. §1016). Improvements made during Lucille's life tenancy increase the total basis, and tax losses or deductions related to the property decrease it.

Question 4. Do the life estate and a remainder interest qualify for the basis adjustment to the date-of-death value?

Answer 4. Yes, because the property was in Bart's estate, its basis is adjusted to the value of the property on his date of death. However, if Bart no longer lived in the property, and he had deeded the house to Donny before he died, subject to a life estate for Lucille, the gift basis rules would apply because the property would not be included in Bart's estate.

FIGURE 1.7 Excerpt from Tables of IRS Publication 1457

Table S (5.8) **Section 1**

Single Life Factors Based on Life Table 90CM

Interest at 5.8 Percent

Age	Annuity	Life Estate	Remainder	Age	Annuity	Life Estate	Remainder
0	16.6452	.96542	.03458	**55**	12.0830	.70082	.29918
1	16.7723	.97279	.02721	**56**	11.8796	.68901	.31099
2	16.7576	.97194	.02806	**57**	11.6713	.67694	.32306
3	16.7379	.97080	.02920	**58**	11.4590	.66462	.33538
4	16.7152	.96948	.03052	**59**	11.2434	.65211	.34789
5	16.6899	.96801	.03199	**60**	11.0246	.63942	.36058
6	16.6626	.96643	.03357	**61**	10.8023	.62653	.37347
7	16.6331	.96472	.03528	**62**	10.5759	.61340	.38660
8	16.6019	.96291	.03709	**63**	10.3453	.60003	.39997
9	16.5682	.96096	.03904	**64**	10.1109	.58643	.41357
10	16.5321	.95886	.04114	**65**	9.8728	.57262	.42738
11	16.4937	.95664	.04336	**66**	9.6305	.55857	.44143
12	16.4531	.95428	.04572	**67**	9.3834	.54424	.45576
13	16.4110	.95184	.04816	**68**	9.1320	.52966	.47034
14	16.3683	.94936	.05064	**69**	8.8771	.51487	.48513
15	16.3255	.94688	.05312	**70**	8.6199	.49996	.50004
16	16.2829	.94441	.05559	**71**	8.3615	.48497	.51503
17	16.2402	.94193	.05807	**72**	8.1027	.46996	.53004
18	16.1971	.93943	.06057	**73**	7.8440	.45495	.54505
19	16.1526	.93685	.06315	**74**	7.5846	.43991	.56009
20	16.1062	.93416	.06584	**75**	7.3236	.42477	.57523
21	16.0575	.93134	.06866	**76**	7.0603	.40950	.59050
22	16.0068	.92840	.07160	**77**	6.7948	.39410	.60590
23	15.9537	.92532	.07468	**78**	6.5276	.37860	.62140
24	15.8978	.92207	.07793	**79**	6.2604	.36310	.63690
25	15.8387	.91865	.08135	**80**	5.9953	.34773	.65227
26	15.7765	.91504	.08496	**81**	5.7343	.33259	.66741
27	15.7107	.91122	.08878	**82**	5.4785	.31775	.68225
28	15.6416	.90721	.09279	**83**	5.2280	.30322	.69678
29	15.5692	.90301	.09699	**84**	4.9810	.28890	.71110
30	15.4934	.89862	.10138	**85**	4.7362	.27470	.72530
31	15.4143	.89403	.10597	**86**	4.4957	.26075	.73925
32	15.3317	.88924	.11076	**87**	4.2626	.24723	.75277
33	15.2452	.88422	.11578	**88**	4.0372	.23416	.76584
34	15.1548	.87898	.12102	**89**	3.8195	.22153	.77847
35	15.0601	.87348	.12652	**90**	3.6096	.20936	.79064
36	14.9612	.86775	.13225	**91**	3.4109	.19783	.80217
37	14.8578	.86175	.13825	**92**	3.2270	.18717	.81283
38	14.7496	.85548	.14452	**93**	3.0576	.17734	.82266
39	14.6365	.84892	.15108	**94**	2.8998	.16819	.83181
40	14.5182	.84205	.15795	**95**	2.7502	.15951	.84049
41	14.3941	.83486	.16514	**96**	2.6097	.15136	.84864
42	14.2643	.82733	.17267	**97**	2.4797	.14382	.85618
43	14.1288	.81947	.18053	**98**	2.3576	.13674	.86326
44	13.9874	.81127	.18873	**99**	2.2386	.12984	.87016
45	13.8408	.80276	.19724	**100**	2.1229	.12313	.87687
46	13.6886	.79394	.20606	**101**	2.0090	.11652	.88348
47	13.5314	.78482	.21518	**102**	1.8971	.11003	.88997
48	13.3689	.77540	.22460	**103**	1.7862	.10360	.89640
49	13.2010	.76566	.23434	**104**	1.6679	.09674	.90326
50	13.0275	.75559	.24441	**105**	1.5523	.09003	.90997
51	12.8484	.74521	.25479	**106**	1.4039	.08143	.91857
52	12.6644	.73453	.26547	**107**	1.2244	.07101	.92899
53	12.4754	.72357	.27643	**108**	.9462	.05488	.94512
54	12.2817	.71234	.28766	**109**	.4726	.02741	.97259

Sale of Life Interest

The owner of a life estate may be permitted to sell the right to use the property. Because the term interest will still end on the date of death of the original life tenant, it may be difficult to find a buyer for it. Assuming that a buyer can be found, however, the seller may not claim any basis, so any amount received is taxable gain. (The buyer generally may amortize the price paid for a life interest over the original life tenant's life expectancy.)

The zero-basis rule for a separate sale of a life interest is found in I.R.C. §1001(e), which states: "In determining the gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded."

Thus, the zero-basis provision applies to disposition of term interests received as an inheritance (I.R.C. §1014), as a gift (I.R.C. §1015), or in a nontaxable transfer between spouses (I.R.C. §1041).

Example 1.9 Calculating Gain on Sale

Lucille, in Example 1.8, lived in the house for 12 years. At age 60, she decided to move out of the house. The provision for her life estate allows her to receive income from another person's use of the property, and she decides to sell her life estate. Harold, who is a few years older than Lucille, agrees to buy it, figuring he will probably not outlive her remaining life expectancy of about 25 years. At the time of the sale, the fair market value of the house was $650,000. Lucille sold the life interest to Harold for $350,000.

Question 1. How was the sales price determined?

Answer 1. By coincidence, the applicable I.R.C. §7520 rate for the month of sale was the same as the applicable I.R.C. §7520 rate for the month of Bart's death in the previous example—5.8%. Lucille's life estate factor for age 60 is 0.63942. Multiplying that factor times the $650,000 FMV provides a life estate value of $415,623. However, Harold is not guaranteed use of the property for 25 years: If Lucille dies earlier, his tenancy will end then. Therefore, he offered a discounted amount.

Question 2. What is Lucille's gain on the sale?

Answer 2. Her realized gain is $350,000. Per I.R.C. §1001(e), she has a zero basis because she cannot use any of the adjusted uniform basis as an offset to the gain unless the entire property is sold.

Her recognized gain may be as little as $100,000. If she meets the requirements of I.R.C. §121 by owning the life estate for 2 out the 5 years before the sale; living in the house for 2 out of 5 years before the sale; and not using the I.R.C. §121 exclusion for 2 years before the sale, she can exclude up to $250,000 of gain from the sale.

Question 3. What does Donny, who has the remainder interest, have to report?

Answer 3. Nothing. This sale involved only Lucille, the owner of the life estate. Donny's basis in the property is still linked to the $500,000 value in Bart's estate (as adjusted under I.R.C. §1016). Lucille's sale does not affect this.

Question 4. What's in it for Harold? Does he ever recover his investment?

Answer 4. Harold has a $350,000 basis in the property. If he uses the house as his personal residence, the $350,000 is a nondeductible personal expense. If he uses the house in a trade or business, which includes renting it out, he can recover his investment by amortizing it over Lucille's remaining life expectancy.

Practitioner Note Proceeds Are Long-Term Capital Gain

Because the purchaser has use of the property for only a limited time, are the proceeds considered ordinary income, like rent? No, the proceeds received by a life tenant for the transfer of her entire interest are an amount realized from the sale or exchange of a capital asset (Rev. Rul. 72-243, 1972-1 C.B. 233). Because the basis of the property is determined under I.R.C. §1014, I.R.C. §1023 arguably applies to give the life-tenant long-term capital gain even if the life estate is sold within one year of the decedent's death.

Sale of Entire Property

The calculation of gain changes if the entire property is sold instead of just the life estate. In a total sale, both the life tenant and the remainder person have gain or loss to report. Each calculates gain or loss based on an allocable share of the adjusted uniform basis in the property.

Example 1.10 Sale of Property

Instead of selling her separate interest for the $350,000, Lucille talked to Donny, and they agreed to sell the house to an unrelated third party. Donny would rather have some money now than waiting potentially 25 years or more to benefit from the property. They find a buyer willing to pay the full $650,000.

Question 1. What is Lucille's gain or loss on the sale?

Answer 1. Lucille's share of the sales price is $415,623, following the allocation in the previous example. Her basis is recalculated based upon the date of the sale, so the current factor of 0.63942 is applied to the previously determined uniform basis of $500,000, giving her a basis of $319,710. Her gain on the sale is then $95,913 ($415,623 minus $319,710).

Question 2. What is Donny's gain or loss on the sale?

Answer 2. Donny's portion of the sales price is the remaining $234,377, and his portion of the basis is increased to $180,290, so his gain is $54,087.

Sale of Remainder Interest

If only the remainder interest is sold, without a corresponding sale of the life estate, the remainder person calculates gain or loss using the same basis allocation as in Example 1.10. The zero-basis rule for the separate sale of a life estate does not apply to the remainder person's separate sale. However, the remainder person cannot claim the full basis because the life tenant is still entitled to use the uniform basis in determining depreciation, etc. [Treas. Reg. §1.1014-5(a)(3)].

Term Interest Purchased for Business or Investment

The basis rules are different for a taxpayer who buys a term interest in property (instead of inheriting it) that is used in a trade or business or is held for an investment. The general rule is that the purchaser of the term interest can amortize the cost of the term interest over the life of the term.

Example 1.11 Amortization of Term Interest

Acme, Inc. paid Sandy $100,000 for a 20-year term interest in a parcel of unimproved land that it uses in its business. Acme and Sandy are not related parties. Acme can deduct $5,000 each year of the 20-year term to recover its investment in the term interest.

If the remainder interest is owned by a taxpayer who is related to the taxpayer who purchased the term interest, the owner of the term interest is barred from amortizing the cost of the term interest [I.R.C. §167(e)(1)]. For this provision, related parties are those described in I.R.C. §267(b) or (e). See Chapter 2, Related-Party Issues, in the *2005 National Income Tax Workbook* for a discussion of related persons.

Example 1.12 Related Party Owns Remainder Interest

Assume that Sam owns more than 50% of the shares of Acme, Inc., and he purchased the remainder interest in the parcel of land when Acme bought the 20-year term interest. Acme is not allowed to amortize the cost of the term interest. However, Acme must reduce its basis in the term interest by the disallowed amortization deductions and Sam is allowed to add that amount to his basis [I.R.C. §167(e)(3)].

The prohibition of amortizing the cost of the term interest does not prohibit the owner of the term interest from claiming depreciation on the underlying property [I.R.C. §167(e)(4)(B)]. Although the statutory language is not a model of clarity, the committee reports for this provision support this interpretation. They state: "No depreciation or amortization deduction is allowed for a term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person. The provision does not affect a depreciation deduction which is not attributable to a term of years of life estate. Thus, the owner of a term interest in a building cannot amortize the term interest but may claim the depreciation deduction with respect to the underlying building allowed under present law."

Example 1.13 Depreciable Property

If the parcel of land that Acme purchased from Sandy included a building (and Sam bought the remainder interest) Acme cannot amortize the cost of the land, but it can claim depreciation on the full basis of the building.

Practitioner Note Amortization of Term Interest by Gift, Devise, or Inheritance

If the term interest is received by gift, devise, or inheritance, the owner of the term interest cannot claim an amortization deduction for the declining value of the term interest even if the remainder interest is owned by an unrelated party (I.R.C. §273). However, that rule does not bar the owner of the term interest from claiming depreciation on the underlying property.

Personal Residence Exclusion

I.R.C. §121 provides for a $250,000 exclusion ($500,000 if married filing jointly) from gain on the sale of a personal residence if the property was owned by the taxpayer and used as the taxpayer's principal residence for 2 of the last 5 years. If all of the other requirements are met, the exclusion may apply to the sale of either a life estate or a remainder interest, except for the sale of a remainder interest to a related party. But only one maximum limitation amount applies to all of a taxpayer's sales of partial interests [Treas. Reg. §1.121-4(e)(1)(ii)(A)].

If an owner elects to sell only the remainder interest and exclude gain from that sale, gain from any subsequent sale of that taxpayer's interest in the property cannot be excluded. I.R.C. §121(d)(8) specifically states: "At the election of the taxpayer, this section shall not fail to apply to the sale or exchange of an interest in a principal residence by reason of such interest being a remainder interest in such residence, but this section shall not apply to any other interest in such residence which is sold or exchanged separately."

Example 1.14 Personal Residence Exclusion

Jim and Diane sold their home to an unrelated party with the provision that they could live in it for the rest of Diane's life. She has a terminal disease, and they do not expect her to live more than two or three more years. Jim plans to move closer to their children and grandchildren after Diane dies. They have lived in their home for 25 years. Their gain on the sale is $240,000.

Question 1. Can Jim and Diane exclude the gain under I.R.C. §121?

Answer 1. Yes. They meet the qualifications to exclude the gain.

Question 2. What if they decide to move out sooner and sell the life estate?

Answer 2. The full amount they receive from the second sale will be reportable in income. There is no I.R.C. §121 exclusion on any sale after sale of a remainder interest.

Question 3. Would it make a difference if the remainder interest is sold to a relative?

Answer 3. Yes. Treas. Reg. §1.121-4(e)(2)(ii)(B) states that the exclusion does not apply if the remainder interest is sold to a relative.

Practitioner Note Exclusion for Life Tenant if Entire Interest Sold

Rev. Rul. 84-43, 1984-1 C.B. 27, provides that the sale of a life estate in a principal residence qualifies for the I.R.C. §121 exclusion if the life estate is the taxpayer's entire interest in the residence. The ruling refers to the prior version of I.R.C. §121 (the one-time exclusion of gain by a taxpayer over the age of 55). But this principle should continue to apply under the revised code section. A ruling published on an I.R.C. §121 issue after the law change (Rev. Rul. 88-29, 1988-1 C.B. 75) reiterates that a life estate is an ownership interest, and Treas. Reg. §1.121-4(e)(1) permits the exclusion to be used in sales of partial interests other than remainder interests.

Practitioner Note Exclusion Hurdle for Remainder Person

All of the basic requirements for the I.R.C. §121 exclusion must be met for sale of a remainder interest to qualify. Many remainder persons will not be able to meet the ownership and use tests. In Ltr. Rul. 8246123, the IRS held that "ownership requires a present right to possession of the property" and that a remainder interest "is a postponed right to possession."

Practitioner Note Adjusted Basis

In some cases, a remainder interest is created by gift, that is, an owner of property gives a remainder interest to the remainder person and retains a life estate. In those cases, the basis of the property is adjusted to its value on the date of the life tenant's death because the full value of the property is in the life tenant's estate under I.R.C. §2036.

Death of an Owner

Death of Life Tenant

At some point the life tenant will die. At that time, the property automatically belongs to the remainder person. It is not valued in the estate of the deceased life tenant because her control of the property ended with her death. Therefore, there is no adjustment to the basis because of her death. The remainder person now has the full uniform basis in the property.

Example 1.15 Death of Life Tenant

When Lucille died, the house went to Donny. Lucille had lived for 10 years after Bart's death, and the house was worth $750,000 at the time of her death. The adjusted uniform basis upon Lucile's death was $550,000 because Lucille had made $50,000 of improvements. Donny sold the house immediately for $750,000. The gain on the sale is $200,000 (sales price less the uniform basis). He does not qualify for the personal residence exclusion.

Death of Remainder Person

What is the basis calculation if the remainder person dies before the life tenant? No adjustment is made to the uniform basis on the death of the remainder person (I.R.C. §1014). The life tenant continues to use the same uniform basis and allocation formula for her tax transactions.

However, the basis of the remainder person's heir is adjusted by the difference between the value of the remainder interest included in the remainder person's estate and the basis of the remainder interest immediately prior to the remainder person's death. Thus, there is a step up (or step down) in basis for the heir of the remainder interest.

Example 1.16 Remainder Person Dies First

Jack died in 2002 and left his second wife, Estelle, a life estate in his house, then valued at $100,000. Upon her death, the house is to go to Jack's daughter Rebecca. Rebecca was killed in a car accident in May 2006, and her daughter Gail inherited the remainder interest in the house. At the time Rebecca died, the house was valued at $160,000. There had been no adjustments to its basis since Jack's death. Estelle was 59 on her birthday nearest to the date of Rebecca's death, and the applicable interest rate under I.R.C. §7520 for May 2006 was 5.8%.

Question 1. What amount of the remainder interest must be included in Rebecca's estate?

Answer 1. The remainder factor from Table S (5.8) is 0.34789. Multiplying that factor by the current value of $160,000 results in a $55,662 value for computing the taxable estate.

Question 2. What is the basis of Gail's inherited remainder interest?

Answer 2. Rebecca's allocated share of the uniform basis immediately before her death was $34,789 ($100,000 × 0.34789). The difference between that and the $55,662 value of the remainder interest for computing the taxable estate is $20,873. At any point in time, Gail figures her adjusted basis by applying the current remainder interest factor based on Estelle's age to the $100,000 uniform basis figure (as adjusted under I.R.C. §1016), and adds the $20,873 amount. Thus, Gail starts out with a basis of $55,662, but this will be adjusted as Estelle ages and for basis additions or decreases under I.R.C. §1016. Because Rebecca did not have a current right to the property at the time of her death, the full value was not included in her estate and Gail does not receive a full adjustment to the entire property's value at the time of Rebecca's death.

Charitable Contribution Deduction

A life estate and remainder interest calculation may also be a factor in a charitable contribution deduction. Generally, a charitable contribution deduction is not allowed until the donor surrenders all interests in the property, unless a trust is established. There is an exception for the contribution of a remainder interest in a personal residence or farm: The donor is entitled to a current year charitable contribution deduction for the net present value of the charitable remainder interest.

Information Required (Treas. Reg. §1.170A-12)

Calculation of the deduction requires determining an expected value for the contributed assets when the life estate ends. To value a remainder interest in real property for the charitable contribution deduction, an allowance for exhaustion, wear and tear, or obsolescence must be taken into account, even though personal use real estate is not truly depreciable, and the property's value must be discounted [I.R.C. §170(f)]. A remainder interest factor from Publication 1457 is applied, just as it was in the preceding examples. Several facts must be determined first:

- FMV of the property on the date the remainder interest is given
- FMV of any attached "depreciable" assets
- Estimated useful life of any "depreciable" improvements
- Salvage value of "depreciable" assets
- Term of years of the life estate
- Applicable rate under I.R.C. §7520

Example 1.17 Donation of House with Life Estate

Mitch, age 62, donated a remainder interest in his house to State College. At the time of the gift, the land was worth $30,000 and the house was worth $100,000. An appraisal determined that the house had a useful life of another 45 years and a $20,000 salvage value at that time. Assume that the applicable federal rate is 5.8% and the remainder factor for age 62 is 0.38660. The value of the remainder interest is a combination of the values of the remainder interests in the nondepreciable and depreciable portions of the property.

Question 1. What is the value of the nondepreciable portion of the property?

Answer 1. The nondepreciable portion is the value of the land plus the salvage value of the house. This is $50,000 ($30,000 plus $20,000).

Question 2. What is the present value of the remainder portion of the nondepreciable portion of the property?

Answer 2. $19,330 [Table S (5.8) remainder factor of 0.38660 times $50,000].

Question 3. What is the value of the depreciable portion of the property?

Answer 3. The depreciable portion is $80,000, the difference between the $100,000 current value of the house and the $20,000 salvage value at the end of 45 years.

Question 4. What is the present value of the remainder portion of the depreciable part of the property?

Answer 4. Treas. Reg. §1.170A-12(b)(2) requires calculating a depreciation adjustment factor using Table C in IRS Publication 1459, Actuarial Values–Book Gimel (111 pages). The complex calculation is shown in Figure 1.8. The bottom line is $21,036.

Question 5. What is Mitch's current year charitable contribution amount?

Answer 5. The total of Answer 2 ($19,330) plus Answer 4 ($21,036), which is $40,366.

Present Value of Depreciable Portion

The formula for calculating the present value of the remainder interest in the depreciable portion of the property is a complex process that starts with factors from Publication 1459. Table C (5.8) is used to make the calculation shown in Figure 1.8. Each page of Table C includes a remainder factor, an R factor, and a D factor for each age from 0 through 109.

FIGURE 1.8 Calculation of Depreciable Property Component

	All Factors Are Taken from Table C (5.8)	
1	R-factor for Mitch's age (62)	14,070.7400000
2	R-factor for terminal age (107)	0.1730166
3	Difference—subtract line 2 from line 1	14,070.5669834
4	D-factor for Mitch's age (62)	2,528.6460000
5	Useful life of house	× 45
6	Product—multiply line 4 by line 5	113,789.0700000
7	Remainder factor (age 62)	0.3866000
8	Depreciation adjustment factor—divide line 3 by line 6	0.1236548
9	Factor for present worth of remainder interest in house (depreciable portion of property)—subtract line 8 from line 7	0.2629452
10	Value of depreciable part of property (from Question 3)	× $80,000
11	Present value of remainder interest in house—multiply line 10 by line 9	$21,036

Taking the Deduction

If the property was held for more than one year (the long-term capital gains holding period) and its current value exceeds its basis, the allowable deduction for the current year is limited to 30% of the donor's modified AGI. There is a 5-year carryforward of any excess amount. Form 8283, Noncash Charitable Contributions, and a copy of the calculation of the contribution's value must be submitted with the return. Because the contribution is likely to be valued at more than $5,000, there must also be a qualified appraisal.

Practitioner Note Depreciation Recapture

Any amount that would have to be reported in ordinary income as depreciation recapture if the property had been sold must be deducted from the property's fair market value before any of the preceding calculations are done.

ISSUE 6: EMERGENCY WORKERS Many rescue workers called in after hurricanes, tornados, fires, and floods are employed temporarily or as volunteers. This section looks at the income consequences for disaster workers, volunteer firefighters, and others, such as reserve deputies, who may receive minimal pay and reimbursements for expenses.

1

Social Security Tax Exclusion

I.R.C. §61 states that, except as otherwise provided, "gross income means all income from whatever source derived." Even when pay is minimal, it is still taxable unless there is a specific exclusion in the Internal Revenue Code. Generally, temporary workers are subject to the same payroll tax rules that apply to permanent workers. However, wages paid to temporary workers hired by federal, state, or local governments to deal with an emergency qualify for an exemption from social security and Medicare coverage under I.R.C. §§3121(b)(6)(C) and 3121(u)(2)(B) if the employment meets the requirements of those subsections.

Practitioner Note No Exception to Income Tax Withholding

There is no similar exception to income tax withholding. Income tax withholding on wages paid to emergency workers is based on the employee's Form W-4.

For the social security and Medicare tax exemption to apply, the employee must be hired to perform services on a **temporary basis** on account of a storm, snow, earthquake, flood, or similar emergency. There cannot be an intention of making the person a permanent employee. How long is temporary? It depends upon the emergency. Temporary is defined by facts and circumstances. If a temporary employee later becomes a permanent employee, subsequent wages are no longer eligible for the exclusion.

A permanent government employee assigned to help in a particular emergency is still a permanent employee, and the wages paid for his or her emergency services are not eligible for the emergency worker exclusion. This is true whether the employee is working part-time, full-time, or additional time dealing with the emergency. For example, overtime wages paid to police officers for work during an emergency do not come under the emergency exemption; they are subject to the regular rules for social security and Medicare coverage.

Practitioner Note Pension Plan Coverage

Wages paid to state and local government employees who are covered by a public employee retirement plan are exempt from social security tax unless there is a Social Security Act §218 agreement between the government agency and the Social Security Administration (42 U.S.C. 418). For more information about these agreements, see IRS Publication 963, Federal-State Reference Guide.

What Is Temporary?

What if the person does not work regularly scheduled hours but instead is on call or works intermittently? Consider the situation of a volunteer firefighter who serves whenever the need arises. This classification requires an exercise of judgment. The criteria to determine whether a firefighter is an employee are the same as for other workers. It does not matter whether the workers are called volunteers. Any worker who receives compensation for services performed and is subject to the will and control of an employer is a common-law employee. About three-quarters of the U.S. fire service is made up of volunteer firefighters, mostly working in small towns or rural communities. The fire department provides training, equipment, and direction, and many of these firefighters are considered employees of the fire department or district for which they work.

If the workers are employees, their wages must be reported on Form W-2, but are they subject to social security and FICA taxes? The IRS stated in its Summer 2003 *Federal, State, and Local Governments Newsletter* that the I.R.C. §3121 exception for temporary workers who respond to unforeseen emergencies does not apply to workers who work on a recurring, routine, or regular basis, even if their work involves situations that may be considered emergencies. On its Web site, the IRS states that firefighters or other emergency workers who serve or are available on a continuing or regular basis do not meet this test. This implies that firefighters who work regularly but intermittently do not qualify for the emergency worker exclusion.

However, Rev. Rul. 88-36, 1988-1 C.B. 343, includes this information as Question and Answer 3:

> **Question 3.** A township has a small number of regularly employed firefighters. To assist these firefighters, certain residents of the township have volunteered their services in cases of emergency. The township alerts these residents to emergencies by sounding a siren. The township keeps a record of the residents who respond to the emergency calls and periodically pays each such resident a nominal amount for each emergency for which the resident performed services. Are the payments made to the residents by the township subject to the Medicare tax?
>
> **Answer 3.** No. The services are considered to be performed by an employee of a state or political subdivision on a temporary basis in case of fire, storm, snow, earthquake, flood, or other emergency and thus are not subject to the Medicare tax. See Section 3121(u)(2)(B)(ii)(III) of the Code.

Practitioner Note Exception Limited to Government Employees

In some cases, a nonprofit organization has been established to operate a volunteer fire department. The I.R.C. §3121 exception applies only to temporary employees of a government subdivision.

Volunteer Reimbursements

An individual qualifies as a bona fide volunteer if he or she does not have a profit motive for purposes of I.R.C. §162. A bona fide volunteer nevertheless can receive some compensation: A reasonable allowance for expenses, or a nominal fee, may typically be paid by a tax-exempt or governmental employer. Working condition fringe benefits can be excluded from the volunteer's income [Treas. Reg. §1.132-5(r)(1)]. To qualify as a working condition fringe benefit, expense reimbursements must be paid under an accountable plan. Without an accountable plan, the reimbursements are treated as wages if the worker is an employee or as income reportable on Form 1099 if the worker is not an employee.

An accountable plan must meet the following three rules:

- The expenses must be paid or incurred while performing services for the payer.
- The expenses must be adequately accounted for to the payer within a reasonable time period, **and**
- Any excess reimbursement or allowance must be returned within a reasonable time period.

Any amount paid as reimbursement that does not meet these conditions is considered paid under a nonaccountable plan. Therefore, a payment that does not reimburse documented expenses is includible in the volunteer's income. It does not matter whether the amount is called a reimbursement, a per diem, or a payment under a point system.

Example 1.18 Social Security and Medicare Taxes

Elliott and Michelle, husband and wife, live in northern Louisiana. Elliott is a state police officer and Michelle is a secretary. When Elliott was sent downstate to help with the cleanup following Hurricane Katrina, Michelle took a leave of absence from her job and went along to help. While they were there, Elliott was paid his regular salary and Michelle received a small stipend from a charity to help with her expenses. There was no requirement to account for the costs she incurred.

Question 1. Is Elliott's pay exempt from FICA taxes during the cleanup period?

Answer 1. No. His pay is treated the same way that it has always been. The fact that he is working at a disaster location does not make it exempt.

Question 2. Does Michelle have gross income?

Answer 2. Yes. There must be an accountable plan in order for her to exclude the stipend. However, it is not subject to social security taxes if she is not a common-law employee. It also is not subject to self-employment tax if her activities do not amount to a trade or business. Michelle may be able to claim a charitable contribution deduction for her out-of-pocket expenses.

Other Types of Compensation

Because cash payments to part-time workers are not always economically feasible, a government entity needing emergency help may opt for another method of compensation. Both the entity and the volunteer may be confused about the taxability of noncash compensation. Is the value of a special benefit or incentive provided to volunteers taxable? Yes, taxable income includes any economic or financial benefit received by an employee. Unless federal tax law provides a specific exclusion for a fringe benefit, the value of the incentive is reportable as wages.

Property Tax Abatements or Exemptions

Special property tax arrangements appear to be a way to provide financial assistance to volunteers without writing a check, and a reduced tax might well be welcomed by the volunteer. This is not, however, a way to avoid taxable income. Two IRS Chief Counsel Advice memos (CCAs 200227003 and 200302045) concluded that property tax breaks for senior citizens and emergency responders performing volunteer services are taxable. The programs covered in the CCAs required that services be performed in return for the benefits.

Liability Insurance

When volunteers step forward to help in an emergency, liability insurance is needed. In today's world, the possibility of a lawsuit always looms over a volunteer. If the liability insurance cost is born by the entity that recruited the volunteer, it can qualify as a tax-free working condition fringe benefit if the value of the insurance does not exceed the value of the volunteer's services. Treas. Reg. §1.132-5(r)(3) states that:

> An individual is considered a "bona fide volunteer" if the total value of the benefits provided with respect to the volunteer services is substantially less than the total value of the volunteer services the individual provides to an exempt organization or government employer.

Gifts and Gift Certificates

What if the volunteer is given something in lieu of cash? Local merchants may have donated gift certificates or tangible items to be distributed to volunteers. If the work performed is the reason for the "gift," its value is taxable.

Mileage Payments

Volunteers may be reimbursed for mileage under an accountable plan. Volunteer workers who are dealing with Katrina-related activities are allowed a charitable contribution deduction of 32¢ per mile in 2006 if they bear the cost themselves. However, they can be reimbursed at the business standard mileage rate (44.5¢ per mile). Other volunteer workers may only deduct the 14¢ per mile allowable for charitable contributions, and that also is the limit for a reimbursement under an accountable plan. Note that a flat rate payment to a volunteer for responding to a call (such as $5) is not paid under an accountable plan.

Practitioner Note Charitable Contribution Deduction

A volunteer's unreimbursed out-of-pocket costs incurred in providing services to a qualifying entity may be deductible as a charitable contribution [Treas. Reg. §1.170A-1(g)]. Allowable costs equivalent to employee business expenses are treated as a cash contribution to the agency.

Questions and Answers

Question 1. I'm a member of a volunteer fire department and have been for three years. We held a fundraiser recently and part of the money was used to give each member a $100 gift certificate as a thank you. Except for reimbursements of my expenses, this is the only income I have from the department. Is it taxable?

Answer 1. Yes, it is taxable. Your employer gave it to you even though you are a "volunteer" firefighter.

Question 2. What about the de minimis rule?

Answer 2. It sounds good, but there is no de minimis rule for cash or cash equivalent payments.

Question 3. What about tax incentives on the income tax return?

Answer 3. Some states provide tax deductions (Maryland and South Carolina) or credits (Delaware and Oklahoma) for volunteer firefighters or other public safety volunteers. The federal government does not.

ISSUE 7: PUBLIC EMPLOYEES

An individual who performs services for a public entity and is paid from governmental funds is a public employee. Government employers include states, cities, towns, villages, water districts, libraries, public school districts, and similar entities. This section looks at some deduction and income items for public employees.

Employee Business Expenses

Because public employees are engaged in a wide range of occupations, not all of them qualify for all of the employee business expense (EBE) deductions discussed in this section. Whether a specific expense is deductible (I.R.C. §162) must be considered in view of the particular occupation. In all cases, however, deductible employee business expenses must meet the following three requirements:

EBE Requirements

- Ordinary and necessary
- Paid or incurred during the tax year
- Incurred for the purpose of carrying on the trade or business of being an employee

Practitioner Note Ordinary and Necessary

Necessary does not always mean the expense is explicitly required by the employer, although in some instances that is an additional condition for a deduction.

Uniforms

Police officers and firefighters are two groups of employees who might be expected to incur costs for special clothing. Unlike the general rules for EBE, for the cost of clothing to be deductible the employer **must** require special clothing (such as uniforms) to be worn on the job **and** the clothes must not be suitable for ordinary street wear. The cost of protective clothing, such as safety shoes, boots, and helmets, is deductible. If the cost of the clothing is deductible, upkeep costs (laundry and dry-cleaning) also are deductible.

Practitioner Note Employee Choice

It is not sufficient that the employee **chooses** not to wear work clothes any place except at work. If the clothing is suitable for street wear, the employee's decision to wear it only to work does not make its cost deductible.

Meals

Firefighters work long shifts and are normally required to remain at the fire station during meal breaks in case they are needed. Thus, they often end up cooking and eating together at the station, and each firefighter may be assessed an amount to cover the cost of meal preparation.

Generally, an employee's payment for meals is deductible as an EBE only if it qualifies as a business-related travel or entertainment expense. Otherwise, the cost of meals eaten during working hours is a nondeductible personal expense. But I.R.C. §119 allows an exclusion from income for the value of meals (1) furnished by an employer (2) on the business premises and (3) for the employer's convenience. If an employee must pay a fixed charge for the meals, an amount equal to the payment can be excluded from income per I.R.C. §119(b)(3), which states:

> If an employee is required to pay on a periodic basis a fixed charge for his meals, and such meals are furnished by the employer for the convenience of the employer, there shall be excluded from the employee's gross income an amount equal to such fixed charge . . . whether the employee pays the fixed charge out of his stated compensation or out of his own funds . . . (but) only if the employee is required to make the payment whether he accepts or declines the meals.

In other words, if a contribution to the mess fund is a requirement of employment and the meals are furnished on-site by the employer, the employer can reduce the employee's reportable wages by the amount of the required contribution.

Alternatively, the IRS has agreed that a firefighter can take a deduction as an EBE under I.R.C. §162 if a contribution is required by the department but the cost is not excluded under I.R.C. §119 because the meals are not provided by the department [*Sibla v. Commissioner,* 611 F.2d 1260 (CA-9, 1980), rev'ing 68 TC 422 (1977), *action on dec.,* 1985-012 (Dec. 23, 1985), *acq.,* 1985-2 C.B. 1, *nonacq.,* 1978-2 C.B. 4]. The key is that there must be an employer requirement to participate in paying for the meals.

Example 1.19 Mandatory Meal Costs

Fireman Fred Flame and all of his fellow firefighters are mandated by the fire commissioner (through a departmental regulation) to participate in organized meals at the firehouse station. They work 24-hour shifts and are not allowed to leave the fire station during their shifts for any type of personal business. All meals are prepared and eaten at the firehouse. The firefighters are responsible for providing the cooking utensils, collecting the fees, doing the grocery shopping, and preparing the meals. Each person is charged $10 per shift to cover the cost. The fee must be paid whether or not the meals are actually eaten.

Question 1. Can Fireman Fred deduct the $1,500 he paid in 2006?

Answer 1. Yes. He meets all of the requirements, because he is required by his employer to contribute to the meal fund whether or not he eats the meals.

Question 2. What if Fireman Fred is a union member, and the union, not the city, requires the mess fund contribution? He'll be ostracized if he doesn't participate.

Answer 2. Fireman Fred does not qualify for the deduction because the contribution is not a condition of employment.

Question 3. What if the firefighters establish a cooking club, allowing the other firemen to contribute and participate voluntarily?

Answer 3. Again, there is no deduction. Eating at the firehouse does not create an EBE deduction (*Morton v. Commissioner,* T.C. Memo. 1986-132, and *Sloyan v. Commissioner,* T.C. Memo 1985-41). An employer requirement to participate in the mess fund is necessary to make the contribution deductible or excludable.

Practitioner Note Firehouse Not Considered Away from Home

A firefighter is not in travel status while working a 24-hour shift that requires remaining at the firehouse overnight. Furthermore, a firefighter who is assigned on different days to different locations within the same city or general area is not "away from home" (Rev. Rul. 56-49, 1956-1 C.B. 152).

Officials Compensated by Fees

Generally, employee business expenses are deducted as an itemized deduction, from adjusted gross income (AGI), rather than as an above-the-line deduction to arrive at AGI (I.R.C. §62). However, an employee of a state or local government who is paid wholly or in part on a fee basis may deduct the related employee business expenses as an adjustment to gross income [I.R.C. §62(a)(2)(C)].

This deduction is intended to benefit fee-compensated state and local government officials who incur substantial costs in providing services to the government. The Senate Committee Report for the Revenue Reconciliation Act of 1997 (P.L. 105-34) noted that these officials frequently hire employees and incur other expenses in connection with their official duties. By providing an above-the-line deduction, the expenses also become deductible for alternative minimum tax purposes.

Amounts paid to an official from government funds are not fee-basis payments. To qualify, the fees must be paid directly to the employee by the general public (Rev. Rul. 74-608, 1974-2 C.B. 275). Justices of the peace and sheriffs are qualified employees in some localities. In addition, the duties of a notary public qualify as a public office. A qualifying official records the expenses on Form 2106 before taking the deduction on line 24 of Form 1040.

Public Employee Benefits

As with other employees, fringe benefits may result in taxable income to public employees. This section looks at three common benefits: personal use of a vehicle, expense allowances, and employer-provided housing.

Personal Use of Vehicle

An employee's personal use of a vehicle owned by a government agency is a taxable fringe benefit, using the same rules that apply to private-sector employees, unless the vehicle is a qualified non-personal use vehicle. The reason the vehicle is used for personal purposes is not important; what counts is the nature of the vehicle itself. A take-home vehicle does not become a nontaxable benefit just because the employee is on call, whether the employee works for a government agency, or, for example, a utility. Use of the following vehicles can qualify for exclusion from income:

Qualified Non-Personal Use Vehicles

- Police and fire vehicles that are clearly marked
- Unmarked vehicles used by law enforcement officers
- Ambulances or hearses being used for their specific purposes
- Cargo vehicles with a loaded gross vehicle weight over 14,000 pounds
- Delivery trucks with seating for the driver only (or with a jump seat)
- Passenger buses seating at least 20 being used for their specific purpose
- School buses
- Tractors and other special-use farm equipment

Example 1.20 Personal Use of Employer Vehicle

Annette works for the City of Gothamopolis. When the weather is bad, she is on call to help clear the streets if necessary. During the winter, she drives a city-owned four-wheel drive pickup truck to and from work so that she will be able to get back to the city garage if she is needed. The truck has city insignia on both side doors, but it has no other modifications and is not used off-road. Annette agreed in writing that she will only use the truck for commuting to and from work.

Question 1. Is this a taxable fringe benefit?

Answer 1. Yes. She has personal use of a vehicle that does not meet any of the exceptions. Her employer must report the value of her personal use of the vehicle as income on her Form W-2.

Question 2. What if there is not enough space to keep the truck locked up at the city garage, and her employer wants her to keep it in her garage to prevent theft or vandalism?

Answer 2. It doesn't matter. Because the vehicle is not a qualified non-personal use vehicle, her personal use of it for commuting is taxable.

Question 3. How is the income inclusion determined?

Answer 3. Because the vehicle is provided for bona fide noncompensatory reasons and she can use it only for commuting, her employer can value her use under the commuting rule. The value will be $3 round trip or $1.50 one way. However, if Annette is an elected official or is paid at least at federal government Executive Level V ($133,900 for 2006), she will not qualify for this method.

Question 4. Would the answer be different if Annette were a police officer commuting in an unmarked police car?

Answer 4. If she is authorized to carry a gun, make arrests, and execute search warrants, a law enforcement officer's commuting use is a nontaxable fringe benefit.

Expense Allowances

Some public employees are provided with a meal allowance or a clothing allowance. Any cash allowance is subject to the accountable plan rules discussed earlier. The expenses must be connected with the performance of services as an employee and properly accounted for, with any excess payment returned to the employer. Hence, an allowance that does not require substantiation is included in income even if the expenses it covers would otherwise be deductible. On the other hand, a personal expense cannot become deductible merely by reimbursing it through the accountable plan rules.

Example 1.21 Substantiated Expenses

Joe is a police officer who receives a $250 annual allowance to be used for the purchase of uniforms and related equipment. Because the uniforms are a deductible item, the allowance is excluded from his income if he is required to substantiate his expenses and return any excess amount. If Joe is promoted to detective and is required to wear a business suit, any part of the allowance that is spent for suits and other normal business clothing will be included in his income even if he substantiates the cost, because a suit does not meet the deductible clothing requirements.

Cash reimbursements for meals are taxable if they do not meet all of the accountability requirements and if the meals would not separately qualify as a deductible EBE. Although meals provided on the employer's premises for the benefit of the employer can be a tax-free fringe benefit, a reimbursement for on-duty meals eaten elsewhere generally is not excludable.

Housing Subsidies

Some public employees are provided housing as part of their jobs. Forest Service employees often are required to live in remote areas to be near their work; park employees may be required to live in park housing, prison wardens in houses on the prison grounds, and state hospital superintendents on the hospital property. Some public school teachers are now being provided housing at a below-market rent in areas where housing is exceptionally expensive in relation to teacher salaries. The question for all of these employees is: Is the housing or housing assistance taxable?

Free or Reduced Rent

Under I.R.C. §61, all fringe benefits are taxable unless specifically excluded by statute. In most cases, the housing value must be included in income. If it is taxable, it is subject to all payroll taxes.

Example 1.22 Teacher Housing

Juanita is being recruited to teach at a rural school. The school system can't pay competitive salaries, but last year a local businessman donated an apartment building to the school system, and they are using it to offer rent-free housing to teachers. The building is located five miles from the school where Juanita will be teaching.

Question 1. Is the value of the housing taxable?

Answer 1. Yes.

Question 2. What amount is included on her Form W-2, Wage and Tax Statement?

Answer 2. The school system must research comparable rental rates. If, for example, the fair rental value is $500 per month, and Juanita lives there for 12 months during the calendar year, the school district must add $6,000 to Juanita's Form W-2 income.

I.R.C. §119 Exclusion Criteria

Housing can sometimes be provided tax-free, but the rules to qualify for the exclusion from income are very strict. I.R.C. §119(a) states that the fair rental value of employer-provided housing is not taxable if the housing is provided for the convenience of the employer, on the employer's business premises, **and** the employee is required to live in the housing as a condition of employment. The value of housing excluded from income under I.R.C. §119 is also not subject to payroll taxes.

Understanding the following four definitions is critical:

- **Housing:** Actual, physical housing must be provided; a housing allowance or reimbursement is not excluded.
- **Convenience of the employer:** There must be a valid noncompensatory business reason for the employer to provide the housing, (rather than its just being a way to pay the employee). This usually means that there is a reason that the employee must be available for duty at all times.
- **Business premises:** Whether lodging is located on the business premises of the employer is determined by facts. The courts look at where the company carries on a significant part of its business, where the employee performs significant duties, and whether the housing location is integrated into the employer's business activities. Employer-owned residential property that is nearby but that is not located at the work site does not qualify [*Dole v. Commissioner,* 351 F.2d 308 (CA-1, 1965), *aff'ing (per curiam)* 43 T.C. 697 (1965), *acq.,* 1966-2 C.B. 4].
- **Condition of employment:** The U.S. Court of Claims has held that there is no substantial difference between this test and the "convenience of the employer" test [*U.S. Junior Chamber of Commerce v. U.S,* 334 F.2d 660 (1964)]. The employee cannot have a choice of living on-site or off-site and must be required to accept the quarters to perform the job properly.

Example 1.23 Convenience of the Employer

Neil is a state forester. As part of his job, he is required to work the fire watch on a regular basis, and he is on call for any emergency. His employer provides housing within the forest to which he is assigned, and Neil is required to live there. His housing is considered to be for the convenience of his employer and is not taxable to him.

Question 1. What if the house is provided in the town nearest to the forest?

Answer 1. It would not meet the requirement of being on the business premises.

Question 2. Would it help if Neil's employer gave him a signed statement that he was living in the housing for the employer's convenience?

Answer 2. No, on two counts. The housing is not on the business premises, and the signed statement is not considered sufficient to meet the business purpose requirement.

Police Officer Housing

Apartment complexes frequently offer housing rent-free or at a reduced rate to law enforcement officers. The owners expect to benefit from having an off-duty police officer on-site who might be available immediately should the need arise and who could be alerted to keep an eye on any problem area that might develop. In Ltr. Rul. 8002003, the IRS determined that the I.R.C. §119 exclusion did not apply, reasoning that performance of the police officer's city job necessarily prevented him from being available for duty at all times at the apartment complex. Thus, the "free" rent should be reported as income on Form 1099-MISC.

Faculty Housing

I.R.C. §119(d) provides special rules for excluding part of the value of housing provided to employees of an educational institution. The housing must be *qualified campus lodging,* located on or near the campus and furnished to the employee for use as a residence. An educational institution is defined as an organization eligible to receive charitable contributions that maintains a regular faculty and curriculum, with students in attendance on site, or an academic health center.

Under a safe harbor rule, employees generally are required to pay an annualized rent equal to 5% of the appraised value of the qualified campus lodging. An appraiser, not the school staff or trustees, must determine the value of the housing, and the appraisal must be reviewed annually. An employee who does not pay rent of at least 5% of the appraised value of the lodging must include as income the difference between the rent paid and the lesser of (a) the 5% figure or (b) the average rental paid by individuals not affiliated with the institution (non-students and/or non-employees) for comparable lodging provided by the institution (Ltr. Rul. 9816015). This allows a lower rent to be paid if market rents for comparable housing are less than the 5% figure.

Example 1.24 Faculty Housing

State University owns several apartment buildings located near the campus but not actually on the grounds. One of the buildings, with 15 apartments, is dedicated to faculty housing. Non-employees rent three of the apartments for $1,000 per month. The university employees are charged $800 per month. State University hired an appraiser who valued each apartment at $300,000.

Question 1. How much is taxable using the 5% of appraised value?

Answer 1. The annual rental value is $15,000, calculated at 5% of $300,000. The annual rent paid by a teacher is $9,600, so the income inclusion is $5,400.

Question 2. How much is taxable using the average rental alternative?

Answer 2. The average rental charged to others is $1,000, versus the $800 charged to university employees. Therefore, $200 per month is includible in income ($2,400 for the year).

Question 3. What if there were no apartments rented to non-employees in any buildings owned by State University?

Answer 3. The second test would not be applicable, and the 5% rule would kick in.

ISSUE 8: QUESTIONS OF "INTEREST"

This section looks at two issues involving the payment of interest: money deposited in an Islamic bank, and money borrowed from a foreign lender to purchase property in a foreign country.

Islamic Banking

In Shakespeare's *Hamlet,* Polonius pontificates: "Neither a borrower nor a lender be." Preceding Shakespeare by several hundred years is Islamic religious doctrine that prohibits the devout from both making and receiving interest payments (called *riba*). The modern banking system is based on interest rates, which generally are stated as a percentage of the amount owed. Millions of Muslims throughout the world thus face a challenge with their financial dealings. To meet these needs, a worldwide network of commercial banks based upon the Islamic rules of finance has amassed billions of dollars in the last 40 years.

Islam Finance Rules

- Interest (a fixed return) may not be charged on a loan.
- A financier may share in the profit or loss from the venture using the money.
- Investments cannot support forbidden practices or products.

Lender's Income

The interest prohibition doesn't mean there is no cost of obtaining capital. Profit-sharing is permitted, because there is no guaranteed rate of return, and the investor shares in the business risk as well as the potential rewards.

Islamic banks frequently offer checking and savings accounts with no fees and no earnings. The money is simply deposited for safekeeping. There is a guaranteed return of capital, but no opportunity for growth. A depositor wanting to earn additional income may choose to open an investment account, with term deposits that cannot be withdrawn before maturity. The bank invests the money, and profits (or losses) are shared periodically.

In a business context, banks may finance production by purchasing goods not yet manufactured that will be delivered at a future date. The bank thus is assuming the risk associated with the resale value of the pre-purchased merchandise. The bank also may purchase property and resell it to clients on a deferred-payment basis.

Deferred-Payment Sales

Generally, because payment of interest is prohibited, a purchaser is expected to pay for goods and services promptly, before any interest is charged by a non-Islamic lender ("90 days same as cash"). Two sections of the Internal Revenue Code may require that interest be charged in a deferred-payment sale:

- I.R.C. §1274 generally requires imputing the principal (rather than accepting the stated principal) amount if some payments are due more than 6 months after the sale, and the sales price is at least $250,000 (more than $1 million for an individual or small business sale of a farm). Other exclusions include an individual's sale of his or her main home and certain land transfers for up to $500,000 between family members.
- I.R.C. §483 may require treating a portion of the payments as unstated interest if I.R.C. §1274 does not apply, if at least one payment is not due for more than one year after the sale, and if the sales price exceeds $3,000.

Thus, there is no IRS requirement to charge interest or to treat part of the sales price as interest if the full amount is due and paid within 6 months after the sale.

To avoid use of installment purchases when the payment period will be longer, Islamic banks frequently employ a lease arrangement. A business client identifies the equipment or machinery it needs, the bank purchases it (thus becoming the owner), and then leases it to the business client, who may opt to purchase the item eventually.

Avoiding Conditional Sale Treatment

The key to avoiding characterization of a lease as a conditional sale is compliance with the provisions of Rev. Rul. 55-540, 1955-2 C.B. 39, which states that a transaction may be treated for tax purposes as a purchase and sale rather than as a lease or rental agreement if one or more of the following conditions are present:

1. Portions of the periodic payments are specifically applicable to equity to be acquired by the lessee.
2. The lessee will acquire title upon payment of a stated amount of "rentals" required under the contract.
3. The total amount the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure transfer of the title.
4. The agreed upon "rental" payments materially exceed the current fair rental value.
5. The property can be acquired under a purchase option at a price that is nominal in relation to the value of the property at the time when the option may be exercised, as determined when entering into the original agreement, or which is a relatively small amount when compared with the total payments that are required to be made.

6. Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

The ruling goes on to note that one indication of an intent to rent equipment is charging rental payments at an hourly, daily, or weekly rate, or basing them on production, use, mileage, or a similar measure, so that the rental fees are not directly related to the normal purchase price. If an option to purchase is included in the agreement, the price at which the equipment may be acquired should reasonably approximate the anticipated fair market value on the option date.

Avoiding conditional sales treatment permits the lessee to deduct the rental payments for business equipment and provides the lessor with rental income, rather than interest income.

Home Mortgages

Generally, devout Muslims are encouraged to save, to pool family funds, and to purchase their homes for cash. But this isn't always possible, and with the Islamic rules in mind, a new type of mortgage has become available. The Islamic mortgage is a type of shared-equity financing. The buyer makes two monthly payments: a rental payment based on the home's fair rental value, and an additional amount that buys another share of ownership. The rent decreases as the buyer's ownership share increases. However, the house is appraised each year, so that the purchase price of an ownership share will increase if the fair market value of the house increases. In addition, the fair rental value is adjusted annually.

Example 1.25 Islamic Mortgage

Rashad agrees to buy a house in cooperation with an Islamic finance agency. He pays $40,000 toward the $100,000 purchase price and the finance company pays the remaining $60,000. He now owns 40% and the finance company owns 60% of the house. The fair rental value of the house is $1,000 per month. The first month, Rashad pays $600 (60% of $1,000 rent) to the finance company as rent, and he also pays $1,000 to acquire another 1% ownership. The next month, Rashad pays $1,590 ($590 as rent for the 59% of the house that he doesn't own, and $1,000 to buy another 1% ownership interest). This pattern continues for a year, at which time the house is appraised and adjustments are made to the fair rental value and the payment required for a 1% ownership interest. Rashad may purchase additional ownership interests at any time.

The big question, then, is whether there is a deductible mortgage interest payment for the owner-occupant. If the shared-equity arrangement is properly structured under both Islamic principles and federal tax law, the answer is no. The rent payment is based on the fair rental value of the property, rather than on the amount of money that is borrowed. If the criteria of Rev. Rul. 55-540, *supra,* are met, there is no reclassification of the lease as a conditional sale.

Foreign Loans

Tax practitioners generally are familiar with the rules for deducting home mortgage interest. Clients are sometimes confused about whether interest on an otherwise qualifying loan is deductible if the lender and the property securing the loan are outside the United States.

There is no requirement in I.R.C. §163(h)(3) that limits its application to U.S. properties. U.S. citizens are taxed on their worldwide income; similarly, they generally are entitled to deduct worldwide expenses (including mortgage interest and property taxes paid in a foreign country).

If the taxpayer lives and works outside the U.S., some housing expenses may qualify for the foreign housing exclusion or deduction on Form 2555, Foreign Earned Income. Mortgage principal and interest, payments, and property taxes are not considered in the Form 2555 calculation. Thus, the mortgage interest and real estate taxes can still qualify as itemized deductions.

Practitioner Note Effect of Foreign-Earned Income Exclusion

Taxpayers cannot deduct, exclude, or claim a credit for any item that can be allocated to or charged against excluded foreign-earned income. However, this rule applies only to items definitely related to the excluded earned income. It does not apply to items that are not definitely related to any particular type of gross income, such as mortgage interest or real estate taxes on a personal residence (Treas. Reg. §1.119-6).

When a home located in another country is sold, a U.S. seller may qualify for the I.R.C. §121 exclusion (except for certain expatriates). Amounts paid or received in foreign funds must be translated to U.S. currency for tax return reporting. If amounts are retained in foreign banks, rather than being converted to U.S. funds immediately, a currency gain or loss may result. I.R.C. §988 generally treats this as ordinary income or an ordinary loss. However, I.R.C. §988 does not apply to an individual's personal currency transactions except to the extent the expenses of the transaction are deductible under I.R.C. §§162 or 212 (not including expenses incurred in connection with the determination, collection, or refund of taxes). Thus, if a principal residence is sold, and there is a separate currency gain or loss, it is treated as a capital gain or loss. A gain is taxable, but a loss is a nondeductible personal loss under I.R.C. §165.

ISSUE 9: REDUCTION OF PHASE-OUTS

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included a provision for temporarily phasing out the reductions of itemized deductions and exemption deductions for higher-income taxpayers. For tax years beginning in 2006 and 2007, the phase-outs are reduced by 1/3, and in 2008 and 2009 they will be reduced by 2/3. For 2010, there will be no reduction, but in 2011 the phase-out rules will be restored to their 2001 levels.

Reduction of Itemized Deductions

I.R.C. §68 reduces a taxpayer's itemized deductions (but not the standard deduction) if the taxpayer's adjusted gross income (AGI) exceeds an amount that is adjusted annually for inflation. For 2006, the reduction begins at $150,500 for taxpayers who are single, head of household, or married filing a joint return, and at $75,250 for taxpayers who are married filing separately.

Not all deductions are subject to this provision. It reduces the deductions for taxes, most interest expense, charitable contributions, job expenses and most other miscellaneous deductions. However, deductions for medical and dental expenses, investment interest expense, casualty and theft losses, and gambling losses are not affected.

Practitioner Note Exception for 2005 Only

Cash charitable contributions (gifts by cash or check) made after August 27, 2005, and before January 1, 2006, that the taxpayer elected to treat as qualified contributions also were not limited by I.R.C. §68.

For 2005 and prior years, the reduction was the smaller of 3% of the amount by which AGI exceeded the ceiling, or 80% of the itemized deductions affected by the limit. It is figured after any other limit on any itemized deduction is applied.

EGTRRA temporarily phases out this reduction, beginning in 2006. For 2006 and 2007, the reduction is 2/3 of the prior amount; in 2008 and

2009, it will be 1/3, and in 2010, the reduction is eliminated, only to resurface in full in 2011. A 2006 worksheet is illustrated in Figure 1.9.

Example 1.26 Reduction of Itemized Deductions

Rollie N. Dough has three children and files as head of household. His 2006 adjusted gross income is $300,000. His Schedule A (Form 1040) includes $25,000 in mortgage interest expense, $10,000 in investment interest expense, $35,000 in state and local taxes, and $30,000 in charitable contributions, for a total of $100,000. His itemized deductions are reduced by $2,990, as shown in Figure 1.9. Because his marginal tax rate is 33%, eliminating $1,495 of the phase-out reduces his income tax by $493.

FIGURE 1.9 2006 Reduction of Itemized Deductions

1. Enter the total itemized deductions from Schedule A (Form 1040) lines 4, 9, 14, 18, 19, 26, and 27.	1. 100,000
2. Enter the total deductions for the following from Schedule A (Form 1040) line 4, medical and dental expenses; line 13, investment interest; line 19, casualty or theft losses (plus those included on line 27); and gambling losses that are included on line 27.	2. 10,000
3. Subtract line 2 from line 1. If line 3 is zero, enter the amount from line 1 on Schedule A (Form 1040), line 28. Do not complete the rest of this worksheet.	3. 90,000
4. Multiply line 3 by 80%.	4. 72,000
5. Enter the taxpayer's adjusted gross income.	5. 300,000
6. Enter $150,500 ($75,250 if married filing separately).	6. 150,500
7. Subtract line 6 from line 5. If zero or less, the itemized dedcution is not reduced. Enter the amount on line 1 on Schedule A (Form 1040), line 28. Do not complete the rest of this worksheet.	7. 149,500
8. Multiply line 7 by 3%.	8. 4,485
9. Enter the smaller of line 4 or line 8.	9. 4,485
10. Divide line 9 by the number 3.	10. 1,495
11. Subtract line 10 from line 9.	11. 2,990
12. Subtract line 11 from line 1. Enter the result on Schedule A (Form 1040), line 28.	12. 97,010

Phase-out of Exemption Deductions

I.R.C. §151(d)(3) similarly phases out the deduction for personal and dependency exemption deductions when AGI exceeds a level based on filing status. For 2006, the basic deduction is $3,300, and the phase-out levels are shown in Figure 1.10. Note that the phase-out range is $122,500 for each filing status except married filing separately.

FIGURE 1.10 Personal Exemption Phase-out Range

Filing Status	Beginning AGI	Ending AGI
Joint or qualifying widow(er)	$225,750	$348,250
Single	150,500	273,000
Head of household	188,150	310,650
Married filing separately	112,875	174,125

For 2005 and earlier years, the phase-out was calculated at 2% for each $2,500 or part of $2,500 ($1,250 if married filing separately) that the taxpayer's AGI exceeds the beginning AGI amount based on filing status.

EGTRRA temporarily reduces this phase-out. For 2006 and 2007, the reduction is 2/3 of that amount; in 2008 and 2009, it will be 1/3, and in 2010, the phase-out is eliminated, only to resurface in full in 2011. Thus, in 2006, all taxpayers will be permitted to deduct at least $1,100 (1/3 of the base amount) for each exemption. A worksheet for the 2006 phase-out is illustrated in Figure 1.11.

Example 1.27 Phase Out of Exemption Deductions

Rollie, from Example 1.26, claims four exemptions on his tax return. The reduction of the phase-out increases his exemption deduction by $2,640 ($7,920 – $5,280), saving him $871 in federal income tax.

FIGURE 1.11 Reduction of Exemption Deduction

1.	Multiply $3,300 by the number of exemptions claimed on Form 1040, line 6d.	1.	13,200
2.	Enter taxpayer's adjusted gross income from Form 1040, line 38.	2.	300,000
3.	Enter the beginning AGI amount from Figure 1.10 for taxpayer's filing status	3.	188,150
4.	Subtract line 3 from line 2.	4.	111,850
5.	Is line 4 more than $122,500 (more than $61,250 if married filing separately)?	5.	No
5a.	If yes, multiply $1,100 by the number of exemptions claimed and enter this figure on Form 1040, line 42 . Do not complete the rest of this worksheet.	5a.	
5b.	If no, divide line 4 by $2,500 ($1,250 if married filing separately). If the result is not a whole number, increase it to the next whole number.	5b.	45
6.	Multiply line 5 by 2%. Enter the result as a decimal, but not more than 1.0.	6.	0.9
7.	Multiply line 1 by the decimal on line 6.	7.	11,880
8.	Divide line 7 by 1.5.	8.	7,920
9.	Subtract line 8 from line 1. Enter the result on Form 1040, line 42.	9.	5,280

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Practitioner Note Hurricane Katrina Housing

An additional exemption deduction of $500 per displaced person (up to $2,000) can be taken by a taxpayer who provided free housing in his or her own main home for at least 60 consecutive days during 2006 to a person who was displaced as a result of Hurricane Katrina. The additional deduction is not subject to the AGI-based phase-out. The $2,000 maximum is reduced by any housing exemption deduction taken in 2005.

Planning Pointer 2007 Changes to Foreign Tax Credit

The American Jobs Creation Act of 2004 included two changes to the foreign tax credit that will first be effective for tax years beginning in 2007.

The number of baskets will be reduced from nine to two—a passive income category and a general income category. The passive income category will include income currently in that basket, plus some other types of dividends, distributions, and interest.

Overall domestic losses that prevented use of a foreign tax credit can be re-characterized as foreign source losses in succeeding tax years, limited to 50% of the taxpayer's U.S.-source taxable income for the succeeding year.

NOTES