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Author's Biography

Renee C. Nash, J.D. is an accomplished teacher and author. She spent 13 years as Adjunct Professor of Law, McGeorge School of Law, in Sacramento, California, where her specialties included employment law. She was consistently rated by students as one of the school's top teachers. Her other teaching duties included serving as an instructor for the College of Administrative Law and America's Legal Seminars. She has written a number of training materials for various professionals, including attorneys, accountants and corporate executives. She formerly served as legal counsel to the California Newspaper Publishers Association, corporate counsel to McClatchy Newspapers, Inc. and general counsel to News & Review Publishing, Inc. She has published books and educational materials in the areas of advertising law, employment law, first amendment law and many others. She earned her B.A. from the University of California and her J.D. from McGeorge School of Law, where she graduated "With Great Distinction."

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Glossary

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Introduction

Financial planning and income tax considerations go hand-in-hand. When a young couple is deciding whether to buy their first home or deciding how to save for their children's college education, federal income tax considerations are inevitably part of the equation. In planning for retirement, for example, people generally try to put as much money away pre-tax as possible. What are the various ways to achieve this? What are the tax implications if the individual needs the money before retirement?

These are just a few of the key questions addressed by this course. Any type of investment decision or financial plan must include an analysis of many factors, including the risk of the investment, the individual or couple's short term and long term financial needs, and, of course, the tax implications.

Considering federal income tax implications is even more key today in light of recent changes to the capital gains tax structure. As of May 6, 2003 (through 2008), the long-term capital gains rate has been reduced to 15 percent for taxpayers in the 25-percent and higher tax brackets, and to 5 percent for those in the 10- and 15-percent brackets.

If these gains were realized before May 6, 2003, they would have been subject to the old rates of 20 percent for those in the 25-percent and above tax brackets, and 10 percent for those in the 10- and 15-percent tax brackets.

Table I-1. Maximum Capital Gain Rates

IF your net capital gain is from ...	THEN your maximum capital gain rate is ...
Collectibles gain	28%
Gain on qualified small business stock equal to the section 1202 exclusion	28%
Unrecaptured section 1250 gain	25%
Other gain, ¹ and the regular tax rate that would apply is 25% or higher	20% for sales ² before May 6, 2003
	15% for sales ² after May 5, 2003
Other gain, ¹ and the regular tax rate that would apply is lower than 25%	8%³ or 10% for sales ² before May 6, 2003
	5% for sales ² after May 5, 2003

¹“Other gain” means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.

² The term “sales” includes trades, involuntary conversions, and installment payments received.

³ The rate is 8% only for qualified 5-year gain (long-term capital gain from the sale of property you held for more than 5 years and sold before May 6, 2003).

This course is divided into three sections. The first section looks at a number of issues involving the implications of income tax in various types of investment decisions, including real property and mutual fund investments. This section also looks at the important issues of the alternative minimum tax and the passive and at-risk rules.

Section two addresses income tax considerations in retirement planning. It focuses on Individual Retirement Arrangements and other employer-sponsored plans that allow workers to save money for retirement with pre-tax dollars. This section also addresses the potential income tax considerations of social security benefits.

Section three looks at income tax considerations in estate and education planning. It focuses on recent changes in the estate tax rates, tax benefits for survivors, the role of life insurance in financial planning, and methods of saving for education with pre-tax monies.

Part I

Income Tax Considerations in Business Planning and Investments

Chapter 1: Tax Treatment of Investment Income

No investment advisor or financial professional can properly recommend any particular investment or investment strategy without a thorough understanding of its tax consequences. This chapter provides information on the tax treatment of investment income. Investment income generally includes interest, dividends, capital gains, and other types of distributions.

I. Interest Income

In general, any interest that an individual receives or that is credited to an individual's account and can be withdrawn is taxable income. (It does not have to be entered in the person's passbook).

A. TAXABLE INTEREST – GENERAL

Taxable interest includes interest individuals receive from bank accounts, loans they make to others, and other sources. The following are some sources of taxable interest.

1. Dividends That Are Actually Interest

Certain distributions commonly called dividends are actually interest. Persons must report as interest so-called "dividends" on deposits or on share accounts in:

- ☐ Cooperative banks;
- ☐ Credit unions;
- ☐ Domestic building and loan associations;
- ☐ Domestic savings and loan associations;
- ☐ Federal savings and loan associations, and
- ☐ Mutual savings banks.

2. Money Market Mutual Funds

Generally, amounts received from money market mutual funds should be reported as dividends, not as interest.

3. Money Market Certificates, Savings Certificates, Deferred Interest Accounts

When one of these accounts is opened, interest may be paid at fixed intervals of 1 year or less during the term of the account. This generally must be included as interest income when it is actually received or when the individual is entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity.

4. Interest Subject to Penalty for Early Withdrawal

If funds are withdrawn from a deferred interest account before maturity, the owner may have to pay a penalty. Individuals must report the total amount of interest paid or credited to their account during the year, without subtracting the penalty.

5. Money Borrowed to Invest in Money Market Certificate

The interest paid on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest earned on the certificate are two separate items. Individuals must report the total interest earned on the certificate as income. If the individual itemizes deductions, they can deduct the interest paid as investment interest, up to the amount of their net investment income.

Example.

Jane deposited \$5,000 with a bank and borrowed \$5,000 from the bank to make up the \$10,000 minimum deposit required to buy a 6-month money market certificate. The certificate earned \$575 at maturity in 2008, but Jane received only \$265, which represented the \$575 Jane earned minus \$310 interest charged on her \$5,000 loan. The bank gives Jane a Form 1099-INT for 2008 showing the \$575 interest earned. The bank also gives Jane a statement showing that she paid \$310 interest for 2008. Jane must include the \$575 in income. If she itemizes her deductions on Schedule A (Form 1040), she can deduct \$310, subject to the net investment income limit.

6. Interest on Insurance Dividends

Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to the individual in the year it is credited to their account. However, if the individual can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

7. Prepaid Insurance Premiums

Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for an individual to withdraw.

8. U.S. Obligations

Interest on U.S. obligations, such as U.S. Treasury bills, notes and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

9. Interest on Tax Refunds

Interest received on tax refunds is taxable income.

10. Installment Sale Payments

If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. That interest is taxable when it is received. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest.

11. Interest on Annuity Contract

Accumulated interest on an annuity contract sold before its maturity date is taxable.

12. Bonds Traded Flat

If an individual buys a bond at a discount when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if paid later. When the individual receives a payment of that interest, it is a return of capital that reduces the remaining cost basis. Interest that accrues after the date of purchase, however, is taxable interest income for the year received or accrued.

13. Below-Market Loans

If someone makes a below-market gift or demand loan, they must report as interest income any forgone interest from that loan. If an individual receives a below-market loan, they may be able to deduct the forgone interest as well as any interest that was actually paid, but not if it is personal interest. The rules for below-market loans apply to:

- ☐ Gift loans;
- ☐ Pay-related loans;
- ☐ Corporation-shareholder loans;
- ☐ Tax-avoidance loans, and
- ☐ Loans to qualified continuing care facilities (made after October 11, 1985) under a continuing care contract.

A *pay-related loan* is any below-market loan between an employer and an employee or between an independent contractor and a person for whom the contractor provides services.

A *tax-avoidance loan* is any below-market loan where the avoidance of federal tax is one of the main purposes of the interest arrangement.

The rules that apply to a below-market loan depend on whether the loan is a gift loan, demand loan, or term loan:

- ☐ A gift loan is any below-market loan where the forgone interest is in the nature of a gift.

- ❑ A demand loan is a loan payable in full at any time upon demand by the lender. A demand loan is a below-market loan if no interest is charged or if interest is charged at a rate below the applicable federal rate.
- ❑ A demand loan or gift loan that is a below-market loan is generally treated as an arm's-length transaction in which the lender is treated as having made:
 - A loan to the borrower in exchange for a note that requires the payment of interest at the applicable federal rate; and
 - An additional payment to the borrower in an amount equal to the forgone interest.

The borrower is generally treated as transferring the additional payment back to the lender as interest. The lender must report that amount as interest income. The lender's additional payment to the borrower is treated as a gift, dividend, contribution to capital, pay for services, or other payment, depending on the substance of the transaction. The borrower may have to report this payment as taxable income, depending on its classification. These transfers are considered to occur annually, generally on December 31.

A term loan is any loan that is not a demand loan. A term loan is a below-market loan if the amount of the loan is more than the present value of all payments due under the loan.

A lender who makes a below-market term loan other than a gift loan is treated as transferring an additional lump-sum cash payment to the borrower (as a dividend, contribution to capital, etc.) on the date the loan is made. The amount of this payment is the amount of the loan minus the present value, at the applicable federal rate, of all payments due under the loan. An equal amount is treated as original issue discount (OID). The lender must report the annual part of the OID as interest income. The borrower may be able to deduct the OID as interest expense. The following are exceptions to the below-market loan rule:

- ❑ The rules for below-market loans do not apply to any day on which the total outstanding amount of loans between the borrower and lender is \$10,000 or less. This exception applies only to:
 - Gift loans between individuals if the gift loan is not directly used to buy or carry income-producing assets, and
 - Pay-related loans or corporation-shareholder loans if the avoidance of federal tax is not a principal purpose of the interest arrangement.

This exception does not apply to a term loan described above that previously has been subject to the below-market loan rules. Those rules will continue to apply even if the outstanding balance is reduced to \$10,000 or less.

- ❑ Loans to qualified continuing care facilities under continuing care contracts are not subject to the rules for below-market loans for the calendar year if the lender or the lender's spouse is 65 or older at the end of the year.
- ❑ Loans are excluded from the below-market loan rules if their interest arrangements do not have a significant effect on the federal tax liability of the borrower or the lender. These loans include:
 - Loans made available by the lender to the general public on the same terms and conditions that are consistent with the lender's customary business practice,
 - Loans subsidized by a federal, state, or municipal government that are made available under a program of general application to the public,
 - Certain employee-relocation loans,
 - Certain loans from a foreign person, unless the interest income would be effectively connected with the conduct of a U.S. trade or business and would not be exempt from U.S. tax under an income tax treaty,
 - Gift loans to a charitable organization, contributions to which are deductible, if the total outstanding amount of loans between the organization and lender is \$250,000 or less at all times during the tax year, and
 - Other loans on which the interest arrangement can be shown to have no significant effect on the federal tax liability of the lender or the borrower.

All the facts and circumstances are used to determine if the interest arrangement has a significant effect on the federal tax liability of the lender or borrower. Some factors to be considered are:

- ❑ Whether items of income and deduction generated by the loan offset each other,
- ❑ The amount of these items,
- ❑ The cost to the individual of complying with the below-market loan rules, if they were to apply, and
- ❑ Any reasons other than taxes for structuring the transaction as a below-market loan.

If someone structures a transaction to meet this exception, and one of the principal purposes of structuring the transaction in that way is the avoidance of federal tax, the loan will be considered a tax-avoidance loan and this exception will not apply.

For gift loans between individuals, if the outstanding loans between the lender and borrower total \$100,000 or less, the forgone interest to be included in income by the lender and deducted by the borrower is limited to the amount of the borrower's net investment income for the year. If the borrower's net investment income is \$1,000 or less, it is treated as zero. This limit does not apply to a loan if the avoidance of federal tax is one of the main purposes of the interest arrangement.

B. EXCEPTIONS

1. Exempt-Interest Dividends

Exempt-interest dividends received from a regulated investment company (mutual fund) are not included in taxable income. Individuals will receive a notice from the mutual fund telling them the amount of the exempt-interest dividends that were received. Note, however, that exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax.

Although exempt-interest dividends are not taxable, individuals must show them on their tax return. This is an information-reporting requirement and does not change the exempt-interest dividends to taxable income.

2. Interest on VA Dividends

Interest on insurance dividends that are left on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance policies and on National Service Life Insurance policies.

3. Individual Retirement Arrangements (IRAs)

Interest on a Roth IRA generally is not taxable. Interest on a traditional IRA is tax deferred. Individuals generally do not include it in their income until they make withdrawals from the IRA.

II. U.S. Treasury Bills, Notes, and Bonds

Treasury bills, notes, and bonds are direct debts of the U.S. Government. Interest income from Treasury bills, notes, and bonds is subject to federal income tax, but is exempt from all state and local income taxes. Investors should receive Form 1099-INT showing the amount of interest that was paid to them each year.

Payments of principal and interest generally will be credited to an investor's designated checking or savings account by direct deposit through the TREASURY DIRECT system, which allows individual investors to purchase and sell Treasury securities directly via the Internet.

A. TREASURY BILLS

These bills generally have a 4-week, 13-week, 26-week, or 52-week maturity period. They are issued at a discount in the amount of \$1,000 and multiples of \$1,000. The difference between the discounted price an investor pays for the bills and the face value

he or she receives at maturity is interest income. Generally, investors must report this interest income when the bill is paid at maturity.

If an investor reinvests their Treasury bill at its maturity in a new Treasury bill, note, or bond, they will receive payment for the difference between the proceeds of the maturing bill (par amount less any tax withheld) and the purchase price of the new Treasury security. However, the investor must report the full amount of the interest income on each of their Treasury bills at the time it reaches maturity.

B. TREASURY NOTES AND BONDS

Treasury notes have maturity periods of more than 1 year, ranging up to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both of these Treasury issues generally are issued in denominations of \$1,000 to \$1 million. Both notes and bonds generally pay interest every 6 months. Generally, investors report this interest for the year paid. When the notes or bonds mature, investors can redeem these securities for face value.

Treasury notes and bonds are usually sold by auction with competitive bidding. If, after compiling the competitive bids, a determination is made that the purchase price is less than the face value, the investor will receive a refund for the difference between the purchase price and the face value. This amount is considered the original issue discount. However, the original issue discount rules do not apply if the discount is less than one-fourth of 1% (.0025) of the face amount multiplied by the number of full years from the date of original issue to maturity. If the purchase price is determined to be more than the face amount, the difference is a premium.

If an investor sells a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. The individual must report that part of the sales price as interest income for the year of sale.

If an investor buys a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid, the investor must treat it as a return of their capital investment, rather than interest income, by reducing their basis in the bond.

III. State or Local Government Obligations

Interest received on an obligation issued by a state or local government is generally not taxable. The issuer should be able to tell investors whether the interest is taxable. The issuer should also give investors a periodic (or year-end) statement showing the tax treatment of the obligation.

Even if interest on the obligation is not subject to income tax, investors may have to report capital gain or loss when it is sold. Estate, gift, or generation-skipping tax may apply to other dispositions of the obligation.

A. TAX-EXEMPT INTEREST

Interest on a bond used to finance government operations generally is not taxable if the bond is issued by a state, the District of Columbia, a U.S. possession, or any of their political subdivisions. Political subdivisions include:

- ❑ Port authorities;
- ❑ Toll road commissions;
- ❑ Utility services authorities;
- ❑ Community redevelopment agencies; and
- ❑ Qualified volunteer fire departments (for certain obligations issued after 1980).

There are other requirements for tax-exempt bonds. Investors should contact the issuing state or local government agency or see §§ 103 and 141 through 150 of the Internal Revenue Code and the related regulations.

B. OBLIGATIONS THAT ARE NOT BONDS

Interest on a state or local government obligation may be tax exempt even if the obligation is not a bond. For example, interest on a debt evidenced only by an ordinary written agreement of purchase and sale may be tax exempt. Also, interest paid by an insurer on default by the state or political subdivision may be tax exempt.

1. Registration Requirement

A bond issued after June 30, 1983, generally must be in registered form for the interest to be tax exempt.

2. Indian Tribal Government

Bonds issued after 1982 by an Indian tribal government are treated as issued by a state. Interest on these bonds is generally tax exempt if the bonds are part of an issue of which substantially all of the proceeds are to be used in the exercise of any essential government function. However, interest on private activity bonds (other than certain bonds for tribal manufacturing facilities) is taxable.

3. Original Issue Discount

Original issue discount (OID) on tax-exempt state or local government bonds is treated as tax-exempt interest.

4. Information Reporting Requirement

Investors are required to show any tax-exempt interest received on their tax return. This is an information-reporting requirement only; it does not change tax-exempt interest to taxable interest.

C. TAXABLE INTEREST

Interest on some state or local obligations is taxable.

1. Federally Guaranteed Bonds

Interest on federally guaranteed state or local obligations issued after 1983 is generally taxable. This rule does not apply to interest on obligations guaranteed by the following U.S. Government agencies:

- ☐ Bonneville Power Authority (if the guarantee was under the Northwest Power Act as in effect on July 18, 1984);
- ☐ Department of Veterans Affairs;
- ☐ Federal Home Loan Mortgage Corporation;
- ☐ Federal Housing Administration;
- ☐ Federal National Mortgage Association;
- ☐ Government National Mortgage Corporation;
- ☐ Resolution Funding Corporation; and
- ☐ Student Loan Marketing Association.

2. Mortgage Revenue Bonds

The proceeds of these bonds are used to finance mortgage loans for homebuyers. Generally, interest on state or local government home mortgage bonds issued after April 24, 1979, is taxable unless the bonds are qualified mortgage bonds or qualified veterans' mortgage bonds.

3. Arbitrage Bonds

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, is taxable. An arbitrage bond is a bond in which any portion of the proceeds is expected to be used to buy (or to replace funds used to buy) higher yielding investments. A bond is treated as an arbitrage bond if the issuer intentionally uses any part of the proceeds of the issue in this manner.

4. Private Activity Bonds

Interest on a private activity bond that is not a qualified bond (defined below) is taxable. Generally, a private activity bond is part of a state or local government bond issue that meets both of the following requirements:

- ☐ More than 10% of the proceeds of the issue is to be used for a private business use; and.

- ❑ More than 10% of the payment of the principal or interest is:
 - Secured by an interest in property to be used for a private business use (or payments for this property), or
 - Derived from payments for property (or borrowed money) used for a private business use.

Also, a bond is generally considered a private activity bond if the amount of the proceeds to be used to make or finance loans to persons other than government units is more than 5% of the proceeds or \$5 million (whichever is less).

5. Qualified Bond

Interest on a private activity bond that is a qualified bond is tax exempt. A qualified bond is an exempt-facility bond (including an enterprise zone facility bond or New York Liberty bond), qualified student loan bond, qualified small issue bond (including a tribal manufacturing facility bond), qualified redevelopment bond, qualified mortgage bond, qualified veterans' mortgage bond, or qualified 501(c)(3) bond (a bond issued for the benefit of certain tax-exempt organizations).

Interest received on these tax-exempt bonds (except qualified 501(c)(3) bonds and New York Liberty bonds), if issued after August 7, 1986, generally is a "tax preference item" and may be subject to the alternative minimum tax.

6. Enterprise Zone Facility Bonds

Interest on certain private activity bonds issued by a state or local government to finance a facility used in an empowerment zone or enterprise community is tax exempt.

7. New York Liberty Bonds

New York Liberty bonds are bonds issued after March 9, 2002, to finance the construction and rehabilitation of real property in a newly designated "Liberty Zone" of New York City. Interest on these bonds is tax exempt.

8. Market Discount

Market discount on a tax-exempt bond is not tax-exempt. If an investor bought the bond after April 30, 1993, they can choose to accrue the market discount over the period they own the bond and include it in their income currently, as taxable interest. If the investor does not make that choice, or if they bought the bond before May 1, 1993, any gain from market discount is taxable when they dispose of the bond.

D. DISCOUNT ON DEBT INSTRUMENT

In general, a debt instrument, such as a bond, note, debenture, or other evidence of indebtedness, that bears no interest or bears interest at a lower than current market rate will usually be issued at less than its face amount. This discount is, in effect, additional interest income.

The following are some of the types of discounted debt instruments:

- ❑ Corporate bonds;
- ❑ Municipal bonds;
- ❑ Certificates of deposit;
- ❑ Notes between individuals;
- ❑ Stripped bonds and coupons; and
- ❑ Collateralized debt obligations (CDOs).

The discount on these instruments (except municipal bonds) is taxable in most instances. The discount on municipal bonds generally is not taxable.

1. Original Issue Discount (OID)

OID is a form of interest. Investors generally include OID in their income as it accrues over the term of the debt instrument, whether or not they receive any payments from the issuer. A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments. The OID accrual rules generally do not apply to short-term obligations (those with a fixed maturity date of 1 year or less from date of issue).

Investors can treat the discount as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity. This small discount is known as “de minimis” OID.

Example 1.

Edward bought a 10-year bond with a stated redemption price at maturity of \$1,000, issued at \$980 with OID of \$20. One-fourth of 1% of \$1,000 (stated redemption price) times 10 (the number of full years from the date of original issue to maturity) equals \$25. Because the \$20 discount is less than \$25, the OID is treated as zero. (If Edward holds the bond at maturity, he will recognize \$20 (\$1,000 - \$980) of capital gain.)

Example 2.

The facts are the same as in Example 1, except that the bond was issued at \$950. The OID is \$50. Because the \$50 discount is more than the \$25 figured in Example 1, Edward must include the OID in income as it accrues over the term of the bond.

If an investor buys a debt instrument with de minimis OID at a premium, the discount is not includible in their income. If an investor buys a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules.

The OID rules discussed here do not apply to the following debt instruments:

- ❑ Tax-exempt obligations;
- ❑ U.S. savings bonds;
- ❑ Short-term debt instruments (those with a fixed maturity date of not more than 1 year from the date of issue);
- ❑ Obligations issued by an individual before March 2, 1984;
- ❑ Loans between individuals, if all the following are true:
 - The lender is not in the business of lending money;
 - The amount of the loan, plus the amount of any outstanding prior loans between the same individuals, is \$10,000 or less; and
 - Avoiding any federal tax is not one of the principal purposes of the loan.

2. Premium

An investor is considered to have bought a debt instrument at a premium if its adjusted basis immediately after purchase was greater than the total of all amounts payable on the instrument after the purchase date, other than qualified stated interest.

If an investor bought an OID debt instrument at a premium, they generally do not have to report any OID as ordinary income.

3. Acquisition Premium

An investor is considered to have bought a debt instrument at an acquisition premium if both of the following are true:

- ❑ They did not pay a premium; and
- ❑ The instrument's adjusted basis immediately after purchase (including purchase at original issue) was greater than its adjusted issue price. This is the issue price plus the OID previously accrued, minus any payment previously made on the instrument other than qualified stated interest.

Acquisition premium reduces the amount of OID includible in an investor's income.

IV. Certificates of Deposit (CDs)

Individuals who buy a CD with a maturity of more than 1 year must include in income each year a part of the total interest due and report it in the same manner as other OID, as discussed above.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- ❑ Time deposits;
- ❑ Bonus plans;
- ❑ Savings certificates;
- ❑ Deferred income certificates;
- ❑ Bonus savings certificates; and
- ❑ Growth savings certificates.

A. BEARER CD'S

CDs issued after 1982 generally must be in registered form. Bearer CDs are CDs that are not in registered form. They are not issued in the depositor's name and are transferable from one individual to another. Banks must provide the IRS and the person redeeming a bearer CD with a Form 1099-INT.

B. TIME DEPOSIT OPEN ACCOUNT ARRANGEMENT

This is an arrangement with a fixed maturity date in which an investor makes deposits on a schedule arranged between him and his bank. But, there is no actual or constructive receipt of interest until the fixed maturity date is reached. For instance, if an investor and his bank enter into an arrangement under which the investor agrees to deposit \$100 each month for a period of 5 years, interest will be compounded twice a year at 7½%, but payable only at the end of the 5-year period. The investor must include a part of the interest in his income as OID each year. Each year the bank must give the investor a Form 1099-OID to show the amount the investor must include in their income for the year.

C. REDEMPTION BEFORE MATURITY

If, before the maturity date, an investor redeems a deferred interest account for less than its stated redemption price at maturity, they can deduct the amount of OID that they previously included in income but did not receive.

D. RENEWABLE CERTIFICATES

If an investor renews a CD at maturity, it is treated as a redemption and a purchase of a new certificate. This is true regardless of the terms of renewal.

E. FACE-AMOUNT CERTIFICATES

These certificates are subject to the OID rules. They are a form of endowment contracts issued by insurance or investment companies for either a lump-sum payment or periodic payments, with the face amount becoming payable on the maturity date of the certificate.

In general, the difference between the face amount and the amount an investor paid for the contract is OID. Investors must include a part of the OID in their income over the term of the certificate. The issuer must provide the investor with a statement on Form 1099-OID indicating the amount they must include in their income each year.

V. Inflation-Indexed Debt Instruments

If an investor holds an inflation-indexed debt instrument (other than a series I U.S. savings bond), they must report as OID any increase in the inflation-adjusted principal amount of the instrument that occurs while they held the instrument during the year. In general, an inflation-indexed debt instrument is a debt instrument on which the payments are adjusted for inflation and deflation (such as Treasury Inflation-Indexed Securities). Investors should receive Form 1099-OID from the payer showing the amount they must report as OID and any qualified stated interest paid during the year.

A. STRIPPED BONDS AND COUPONS

If an investor strips one or more coupons from a bond and sell the bond or the coupons, the bond and coupons are treated as separate debt instruments issued with OID.

The holder of a stripped bond has the right to receive the principal (redemption price) payment. The holder of a stripped coupon has the right to receive interest on the bond.

Stripped bonds and stripped coupons include:

- ❑ Zero coupon instruments available through the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program and government-sponsored enterprises such as the Resolution Funding Corporation and the Financing Corporation; and
- ❑ Instruments backed by U.S. Treasury securities that represent ownership interests in those securities, such as obligations backed by U.S. Treasury bonds that are offered primarily by brokerage firms.

1. Seller

If an investor strips coupons from a bond and sells the bond or coupons, they must include in income the interest that accrued while they held the bond before the date of sale to the extent they did not previously include this interest in their income. For an obligation acquired after October 22, 1986, investors must also include the market discount that accrued before the date of sale of the stripped bond (or coupon) to the extent they did not previously include this discount in their income.

Investors also must add the interest and market discount that they include in income to the basis of the bond and coupons. This adjusted basis must be allocated between the items the investor keeps and the items they sell, based on the fair market value of the items. The difference between the sale price of the bond (or coupon) and the allocated basis of the bond (or coupon) is the investor's gain or loss from the sale.

Investors should also treat any item they keep as an OID bond originally issued and bought by them on the sale date of the other items. If the investor keeps the bond, they must treat the amount of the redemption price of the bond that is more than the basis of the bond as the OID. If the investor keeps the coupons, they must treat the amount payable on the coupons that is more than the basis of the coupons as the OID.

2. Buyer

If an investor buys a stripped bond or stripped coupon, they must treat it as if it were originally issued on the date it is purchased. If they buy a stripped bond, it should treat as OID any excess of the stated redemption price at maturity over the purchase price. If they buy a stripped coupon, they should treat as OID any excess of the amount payable on the due date of the coupon over their purchase price.

3. Figuring OID

The rules for figuring OID on stripped bonds and stripped coupons depend on the date the debt instruments were purchased, not the date issued.

B. MARKET DISCOUNT BONDS

A market discount bond is any bond having market discount except:

- ☐ Short-term obligations (those with fixed maturity dates of up to 1 year from the date of issue);
- ☐ Tax-exempt obligations that were bought before May 1, 1993;
- ☐ U.S. savings bonds; and
- ☐ Certain installment obligations.

Market discount arises when the value of a debt obligation decreases after its issue date, generally because of an increase in interest rates. If an investor buys a bond on the secondary market, it may have market discount.

When an investor buys a market discount bond, they can choose to accrue the market discount over the period they own the bond and include it in their income currently as interest income. If they do not make this choice, the following rules generally apply:

- ☐ The investor must treat any gain when they dispose of the bond as ordinary interest income, up to the amount of the accrued market discount;
- ☐ The investor must treat any partial payment of principal on the bond as ordinary interest income, up to the amount of the accrued market discount;

- ❑ If the investor borrows money to buy or carry the bond, their deduction for interest paid on the debt is limited.

1. Market Discount

Market discount is the amount of the stated redemption price of a bond at maturity that is more than the investor's basis in the bond immediately after they acquire it. Investors must treat market discount as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price of the bond multiplied by the number of full years to maturity (after the bond is acquired).

If a market discount bond also has OID, the market discount is the sum of the bond's issue price and the total OID includible in the gross income of all holders (for a tax-exempt bond, the total OID that accrued) before they acquired the bond, reduced by their basis in the bond immediately after they acquired it.

2. Bonds Acquired at Original Issue

Generally, a bond that is acquired at original issue is not a market discount bond. If the investor's adjusted basis in a bond is determined by reference to the adjusted basis of another person who acquired the bond at original issue, the investor is also considered to have acquired it at original issue.

A bond acquired at original issue can be a market discount bond if either of the following is true:

- ❑ The investor's cost basis in the bond is less than the bond's issue price; or
- ❑ The bond is issued in exchange for a market discount bond under a plan of reorganization. (This does not apply if the bond is issued in exchange for a market discount bond issued before July 19, 1984, and the terms and interest rates of both bonds are the same.)

The accrued market discount is figured in one of two ways.

- ❑ **Ratable accrual method.** In this method, investors treat the market discount as accruing in equal daily installments during the period in which they hold the bond. They figure the daily installments by dividing the market discount by the number of days after the date they acquired the bond, up to and including its maturity date. Then they multiply the daily installments by the number of days they held the bond to figure their accrued market discount.
- ❑ **Constant yield method.** Instead of using the ratable accrual method, investors can choose to figure the accrued discount using a constant interest rate (the constant yield method). They make this choice by attaching to their timely filed return a statement identifying the bond and stating that they are making a constant interest rate election. The choice takes effect on the date the bond was acquired. If an investor chooses to use this method for any bond, they cannot change their choice for that bond.

Investors can choose to include market discount in income currently if they have not revoked a prior choice to include market discount in income currently within the last 5 calendar years.

Once this choice is made, it will apply to all market discount bonds that are acquired during the tax year and in later tax years. Investors cannot revoke their choice without the consent of the IRS.

3. Effect on Basis

Investors increase the basis of their bonds by the amount of market discount they include in their income.

4. Discount on Short-Term Obligations

When an investor buys a short-term obligation (one with a fixed maturity date of 1 year or less from the date of issue), other than a tax-exempt obligation, they can generally choose to include any discount and interest payable on the obligation in income currently. If they do not make this choice, the following rules generally apply.

- ❑ The investor must treat any gain when they sell, exchange, or redeem the obligation as ordinary income, up to the amount of the ratable share of the discount; and
- ❑ If they borrow money to buy or carry the obligation, their deduction for interest paid on the debt is limited.

Investors must include any discount or interest in current income as it accrues for any short-term obligation (other than a tax-exempt obligation) that is:

- ❑ Held by an accrual-basis taxpayer;
- ❑ Held primarily for sale to customers in the ordinary course of the investor's trade or business;
- ❑ Held by a bank, regulated investment company, or common trust fund;
- ❑ Held by certain pass-through entities;
- ❑ Identified as part of a hedging transaction; or
- ❑ A stripped bond or stripped coupon held by the person who stripped the bond or coupon (or by any other person whose basis in the obligation is determined by reference to the basis in the hands of that person).

C. ELECTION TO REPORT ALL INTEREST AS OID

Generally, investors can elect to treat all interest on a debt instrument acquired during the tax year as OID and include it in income currently. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market

discount, de minimis market discount, and unstated interest as adjusted by any amortizable bond premium or acquisition premium.

1. When To Report Interest Income

When an investor should report their interest income depends on whether they use the cash method or an accrual method to report income. Most individual taxpayers use the cash method. If an investor uses this method, they generally report their interest income in the year in which they actually or constructively receive it. However, there are special rules for reporting the discount on certain debt instruments.

Example.

On September 1, 2006, Richard loaned another individual \$2,000 at 12%, compounded annually. Richard is not in the business of lending money. The note stated that principal and interest would be due on August 31, 2008. In 2008, Richard received \$2,508.80 (\$2,000 principal and \$508.80 interest). If Richard uses the cash method, he must include in income on his 2008 return the \$508.80 interest he received in that year.

A person constructively receives income when it is credited to their account or made available to them. A person does not need to have physical possession of it. For example, an investor is considered to have received interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to their account and subject to their withdrawal. This is true even if they are not yet entered in the individual's passbook.

An individual constructively receives income on the deposit or account even if they must:

- ❑ Make withdrawals in multiples of even amounts;
- ❑ Give a notice to withdraw before making the withdrawal;
- ❑ Withdraw all or part of the account to withdraw the earnings; or
- ❑ Pay a penalty on early withdrawals, unless the interest they are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

If an investor uses an accrual method, they report interest income when they earn it, whether or not they have received it. Interest is earned over the term of the debt instrument.

Example.

If, in the previous example, Richard uses an accrual method, he must include the interest in his income as he earns it. He would report the interest as follows: 2006, \$80; 2007, \$249.60; and 2008, \$179.20.

VI. Dividends

Dividends are distributions of money, stock, or other property paid to an individual by a corporation. Individuals also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts received that are called dividends are actually interest income. The most common kinds of distributions are:

- ❑ Ordinary dividends;
- ❑ Capital gain distributions; and
- ❑ Nontaxable distributions.

Most distributions are paid in cash (check). However, distributions can consist of more stock, stock rights, other property, or services.

A. DIVIDENDS ON STOCK SOLD

If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must include the dividend in income.

B. DIVIDENDS RECEIVED IN JANUARY

If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend or capital gain distribution) in October, November, or December payable to shareholders of record on a date in one of those months but actually pays the dividend during January of the next calendar year, the shareholders are considered to have received the dividend on December 31. Investors report the dividend in the year it was declared.

C. ORDINARY DIVIDENDS

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to individual investors unless they are qualified dividends. This means they are not capital gains. Although they are not capital gains, if they are qualified dividends, they are subject to the new capital gains rates rather than ordinary income rates. Investors can assume that any dividend they received on common or preferred stock is an ordinary dividend unless the paying corporation tells them otherwise.

D. DIVIDENDS USED TO BUY MORE STOCK

The corporation in which an investor owns stock may have a dividend reinvestment plan. This plan lets investors choose to use their dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If someone is a member of this type of plan and they use their dividends to buy more stock at a price equal to its fair market value, they still must report the dividends as income.

If someone is a member of a dividend reinvestment plan that lets people buy more stock at a price less than its fair market value, they must report as dividend income the fair market value of the additional stock on the dividend payment date.

Investors also must report as dividend income any service charge subtracted from their cash dividends before the dividends are used to buy the additional stock. But they may be able to deduct the service charge.

In some dividend reinvestment plans, investors can invest more cash to buy shares of stock at a price less than fair market value. If individuals choose to do this, they must report as dividend income the difference between the cash they invest and the fair market value of the stock they buy. When figuring this amount, investors should use the fair market value of the stock on the dividend payment date.

E. CAPITAL GAIN DISTRIBUTIONS

Capital gain distributions (also called capital gain dividends) are paid to investors or credited to their account by regulated investment companies (commonly called mutual funds) and real estate investment trusts (REITs), discussed in more detail below. Capital gain distributions should be reported as long-term capital gains, regardless of how long the individual owned their shares in the mutual fund or REIT.

1. Undistributed Capital Gains of Mutual Funds and REITs

Some mutual funds and REITs keep their long-term capital gains and pay tax on them. Investors must treat their share of these gains as distributions, even though they did not actually receive them. However, they are not included on Form 1099-DIV.

2. Basis Adjustment

Investors should increase their basis in a mutual fund, or their interest in a REIT, by the difference between the gain they report and the credit they claim for the tax paid.

3. Nontaxable Distributions

Investors may receive a return of capital or a tax-free distribution of more shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

4. Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of a person's investment in the stock of the company. Investors should receive a Form 1099-DIV or other statement from the corporation showing which part of the distribution is a return of capital.

A return of capital reduces the basis of the investor's stock. It is not taxed until the basis in the stock is fully recovered. If the investor buys stock in a corporation in different lots at different times, and cannot definitely identify the shares subject to the return of capital, investors should reduce the basis of their earliest purchases first.

When the basis of an investor's stock has been reduced to zero, they should report any additional return of capital that they received as a capital gain. Whether it is reported as a long-term or short-term capital gain depends on how long the investor has held the stock.

Example.

Richard bought stock in 1991 for \$100. In 1994, he received a return of capital of \$80. He did not include this amount in his income, but he reduced the basis of his stock to \$20. Richard received a return of capital of \$30 in 2008. The first \$20 of this amount reduced his basis to zero. Richard reports the other \$10 as a long-term capital gain for 2008. Richard must report as a long-term capital gain any return of capital he received on this stock in later years.

VII. Real Estate Investment Trusts

A REIT is a company that owns, and in most cases, operates income-producing real estate such as apartments, shopping centers, offices, hotels and warehouses. Some REITs also engage in financing real estate. The shares of most REITs are freely traded, usually on a major stock exchange.

A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income. As a result, most REITs remit at least 100 percent of their taxable income to their shareholders and therefore owe no corporate tax. Taxes are paid by shareholders on the dividends received and any capital gains.

Most states honor this federal treatment and also do not require REITs to pay state income tax. To qualify as a REIT, a company must distribute at least 90 percent of its taxable income to its shareholders annually. However, like other businesses, but unlike partnerships, a REIT cannot pass any tax losses through to its investors.

REITs are total return investments. They typically provide high dividends plus the potential for moderate, long-term capital appreciation. Long-term total returns of REIT stocks are likely to be somewhat less than the returns of high-growth stocks and somewhat more than the returns of bonds. Because most REITs also have a small-to-medium equity market capitalization, their returns should be comparable to other small to mid-sized companies.

REITs invest in a variety of property types: shopping centers, apartments, warehouses, office buildings, hotels, and others. Some REITs specialize in one property type only, such as shopping malls, self-storage facilities or factory outlet stores. Health care REITs specialize in health care facilities, including acute care, rehabilitation and psychiatric hospitals, medical office buildings, nursing homes and assisted living centers.

REITs are required by law to distribute each year to their shareholders at least 90 percent of their taxable income. Thus, as investments, REITs tend to be among those companies paying the highest dividends. The dividends come primarily from the relatively stable and predictable stream of contractual rents paid by the tenants who occupy the REIT's properties. Since rental rates tend to rise during periods of inflation, REIT dividends tend to be protected from the long-term corrosive effect of rising prices.

For REITs, dividend distributions for tax purposes are allocated to ordinary income, capital gains and return of capital, each of which may be taxed at a different rate. All public companies, including REITs, are required to provide their shareholders early in the year with information clarifying how the prior year's dividends should be allocated for tax purposes. This information is distributed by each company to its list of shareholders on IRS Form 1099-DIV.

A return of capital distribution is defined as that part of the dividend that exceeds the REIT's taxable income. Because real estate depreciation is such a large non-cash expense that may overstate any decline in property values, the dividend rate divided by Funds From Operations (FFO) or Adjusted Funds From Operations (AFFO) is used by many as a measure of the REIT's ability to pay dividends.

A return of capital distribution is not taxed as ordinary income. Rather, the investor's cost basis in the stock is reduced by the amount of the distribution. When shares are sold, the excess of the net sales price over the reduced tax basis is treated as a capital gain for tax purposes. So long as the appropriate capital gains rate is less than the investor's marginal ordinary income tax rate, a high return of capital distribution may be especially attractive to investors in higher tax brackets.

VIII. Liquidation Distributions

Liquidating distributions, sometimes called liquidating dividends, are distributions received during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments.

Any liquidating distribution received is not taxable to an individual investor until they have recovered the basis of their stock. After the basis of their stock has been reduced to zero, they must report the liquidating distribution as a capital gain (except in certain instances involving collapsible corporations). Whether an investor reports the gain as a long-term or short-term capital gain depends on how long they have held the stock.

A. STOCK ACQUIRED AT DIFFERENT TIMES

If someone acquired stock in the same corporation in more than one transaction, they own more than one block of stock in the corporation. If the person receives distributions from the corporation in complete liquidation, they must divide the distribution among the blocks of stock they own in the following proportion: the number of shares in that block over the total number of shares they own. Divide distributions in partial liquidation among that part of the stock that is redeemed in the partial liquidation. After the basis of a block of stock is reduced to zero, the investor must report the part of any later distribution for that block as a capital gain.

B. DISTRIBUTIONS LESS THAN BASIS

If the total liquidating distributions received is less than the basis of an investor's stock, they may have a capital loss. An investor can report a capital loss only after they have received the final distribution in liquidation that results in the redemption or cancellation of the stock. Whether they report the loss as a long-term or short-term capital loss depends on how long they held the stock.

C. DISTRIBUTIONS OF STOCK AND STOCK RIGHTS

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to acquire the corporation's stock. Generally, stock dividends and stock rights are not taxable to the individual investor, and they do not report them on their return.

1. Taxable Stock Dividends and Stock Rights

Distributions of stock dividends and stock rights are taxable if any of the following apply:

- ☐ The investor or any other shareholder has the choice to receive cash or other property instead of stock or stock rights;
- ☐ The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders;
- ☐ The distribution is in convertible preferred stock and has the same result as above;
- ☐ The distribution gives preferred stock to some common stock shareholders and common stock to other common stock shareholders; or
- ☐ The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term "stock" includes rights to acquire stock, and the term "shareholder" includes a holder of rights or convertible securities. If an individual receives taxable stock dividends or stock rights, they must include their fair market value at the time of the distribution in their income.

2. Constructive Distributions

Investors must treat certain transactions that increase their proportionate interest in the earnings and profits or assets of a corporation as if they were distributions of stock or stock rights. These constructive distributions are taxable if they have the same result as a distribution described above.

This treatment applies to a change in an investor's stock's conversion ratio or redemption price, a difference between their stock's redemption price and issue price, a redemption that is not treated as a sale or exchange of their stock, and any other transaction having a similar effect on their interest in the corporation.

3. Preferred Stock Redeemable at a Premium

If an investor holds preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock.

For stock issued before October 10, 1990, investors should include the redemption premium in their income ratably over the period during which the stock cannot be redeemed. For stock issued after October 9, 1990, they should include the redemption premium on the basis of its economic accrual over the period during which the stock cannot be redeemed, as if it were original issue discount on a debt instrument.

The redemption premium is not a constructive distribution, and therefore is not taxable, in the following situations:

- ❑ The stock was issued before October 10, 1990 (before December 20, 1995, if redeemable solely at the option of the issuer), and the redemption premium is "reasonable." (For stock issued before October 10, 1990, only the part of the redemption premium that is not "reasonable" is a constructive distribution.) The redemption premium is reasonable if it is not more than 10% of the issue price on stock not redeemable for 5 years from the issue date or is in the nature of a penalty for making a premature redemption;
- ❑ The stock was issued after October 9, 1990 (after December 19, 1995, if redeemable solely at the option of the issuer), and the redemption premium is "de minimis." The redemption premium is de minimis if it is less than one-fourth of 1% (.0025) of the redemption price multiplied by the number of full years from the date of issue to the date redeemable;
- ❑ The stock was issued after October 9, 1990, and must be redeemed at a specified time or is redeemable at the investor's option, but the redemption is unlikely because it is subject to a contingency outside their control (not including the possibility of default, insolvency, etc.);
- ❑ The stock was issued after December 19, 1995, and is redeemable solely at the option of the issuer, but the redemption premium is in the nature of a penalty for premature redemption or redemption is not more likely than not to occur. The redemption will be treated under a "safe harbor" as not more likely than not to occur if all of the following are true:
 - The investor and the issuer are not related;
 - There are no plans, arrangements, or agreements that effectively require or are intended to compel the issuer to redeem the stock; or
 - The redemption would not reduce the stock's yield.

4. Fractional Shares

An individual investor may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued, but instead are sold, and the cash proceeds are given to the shareholders. Any cash received for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. An investor must determine their gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Their gain or loss is the difference between the cash they receive and the basis of the fractional shares sold.

Example.

Linda owns one share of common stock that she bought on January 3, 1995, for \$100. The corporation declared a common stock dividend of 5% on June 30, 2008. The fair market value of the stock at the time the stock dividend was declared was \$200. Linda was paid \$10 for the fractional-share stock dividend under a plan described in the above paragraph. She figures her gain or loss as follows:

Fair market value of old stock \$200.00
Fair market value of stock dividend
(cash received) + 10.00
Fair market value of old stock and stock dividend \$210.00
Basis (cost) of old stock after the stock dividend
 $((\$200 \div \$210) \times \$100)$ \$95.24
Basis (cost) of stock dividend
 $((\$10 \div \$210) \times \$100) + 4.76$
Total \$100.00
Cash received \$10.00
Basis (cost) of stock dividend - 4.76

Gain \$5.24

Because Linda had held the share of stock for more than 1 year at the time the stock dividend was declared, her gain on the stock dividend is a long-term capital gain.

5. Scrip Dividends

A corporation that declares a stock dividend may issue investors a scrip certificate that entitles them to a fractional share. The certificate is generally nontaxable when it is received. If the investor chooses to have the corporation sell the certificate for them and give them the proceeds, their gain or loss is the difference between the proceeds and the part of their basis in the corporation's stock that is allocated to the certificate.

However, if an investor receives a scrip certificate that they can choose to redeem for cash instead of stock, the certificate is taxable when it is received. Investors must include its fair market value in income on the date they receive it.

6. Other Distributions

Investors may receive any of the following distributions during the year:

- ❑ **Exempt-interest dividends.** Exempt-interest dividends received from a regulated investment company (mutual fund) are not included in the investor's taxable income. They will receive a notice from the mutual fund telling them the amount of the exempt-interest dividends they received. Exempt-interest dividends are not shown on Form 1099-DIV or Form 1099-INT.
- ❑ **Information reporting requirement.** Although exempt-interest dividends are not taxable, an investor must show them on their tax return if they have to file a return. This is an information reporting requirement and does not change the exempt-interest dividends to taxable income.
- ❑ **Alternative minimum tax treatment.** Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax.
- ❑ **Dividends on insurance policies.** Insurance policy dividends that the insurer keeps and uses to pay their premiums are not taxable. However, investors must report as taxable interest income the interest that is paid or credited on dividends left with the insurance company. If dividends on an insurance contract (other than a modified endowment contract) are distributed to them, they are a partial return of the premiums they paid. They should not be included in gross income until they are more than the total of all net premiums the investor paid for the contract.
- ❑ **Dividends on veterans' insurance.** Dividends received on veterans' insurance policies are not taxable. In addition, interest on dividends left with the Department of Veterans Affairs is not taxable.
- ❑ **Patronage dividends.** Generally, patronage dividends received in money from a cooperative organization are included in an investor's income.

7. Stripped Preferred Stock

If the dividend rights are stripped from certain preferred stock, the holder of the stripped preferred stock may have to include amounts in income equal to the amounts that would have been included if the stock were a bond with original issue discount (OID).

Stripped preferred stock is any stock that meets both of the following tests:

- ❑ There has been a separation in ownership between the stock and any dividend on the stock that has not become payable.

❑ The stock:

- Is limited and preferred as to dividends;
- Does not participate in corporate growth to any significant extent; and
- Has a fixed redemption price.

If an investor buys stripped preferred stock after April 30, 1993, they must include certain amounts in their gross income while they hold the stock. These amounts are ordinary income. They are equal to the amounts the investor would have included in gross income if the stock were a bond that:

- ❑ Was issued on the purchase date of the stock; and
- ❑ Has OID equal to the redemption price for the stock, minus the price at which they bought the stock.

CHAPTER 1 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Taxable interest includes interest individuals receive from bank accounts, loans made to others, and other sources.
 - a) true
 - b) false
2. Interest received from U.S. obligations, such as Treasury bills, is never subject to taxation.
 - a) true
 - b) false
3. Ordinary corporate dividends are normally treated as capital gains.
 - a) true
 - b) false

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** The general presumption is that interest income is taxable. Common sources include interest from a bank account and other types of investments, such as corporate dividends.

B: False is incorrect. Although some types of interest payments are exempt from taxation, the general presumption is in favor of taxation.

(See page 1-1 of the course material.)

2. A: True is incorrect. Although many governmental securities are exempt from state and local taxation, income from U.S. securities is subject to federal taxes.

B: False is correct. Interest on U.S. obligations, such as U.S. Treasury bills, notes and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

(See page 1-6 of the course material.)

3. A: True is incorrect. These are generally not treated as capital gains.

B: False is correct. Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to individual investors. This means they are not capital gains. Investors can assume that any dividend they received on common or preferred stock is an ordinary dividend unless the paying corporation tells them otherwise.

(See page 1-19 of the course material.)

Chapter 2: Deductions of Investment Expenses

I. Limits on Deductions

An individual's deductions for investment expenses may be limited by a number of rules, including the following:

- ❑ The at-risk rules;
- ❑ The passive activity loss limits;
- ❑ The limit on investment interest; or
- ❑ The 2% limit on certain miscellaneous itemized deductions.

A. AT-RISK RULES

Special at-risk rules apply to most income-producing activities. These rules limit the amount of loss that an investor can deduct to the amount they risk losing in the activity. Generally, this is the amount of cash and the adjusted basis of property the investor contributes to the activity. It also includes money the investor borrows for use in the activity if they are personally liable for repayment or if they use property not used in the activity as security for the loan. This subject will be discussed in more detail in Chapter 3.

B. PASSIVE ACTIVITY LOSSES AND CREDITS

A passive activity generally is any activity involving the conduct of any trade or business in which the investor does not materially participate and any rental activity. However, if the individual is involved in renting real estate, the activity is not a passive activity if both of the following are true:

- ❑ More than one-half of the personal services the investor performs during the year in all trades or businesses are performed in real property trades or businesses in which he or she materially participates; and
- ❑ The investor performs more than 750 hours of services during the year in real property trades or businesses in which he or she materially participates.

The terms *trade* or *business* generally means any activity that involves the conduct of a trade or business, is conducted in anticipation of starting a trade or business, or involves certain research or experimental expenditures. However, it does not include rental activities or certain activities treated as incidental to holding property for investment. Investors are considered to materially participate in an activity if they are involved on a regular, continuous, and substantial basis in the operations of the activity.

The amount of losses and tax credits an individual can claim from passive activities is limited. Generally, taxpayers are allowed to deduct passive activity losses only up to the amount of their passive activity income. Also, taxpayers can use credits from passive activities only against tax on the income from passive activities. There are exceptions for

certain activities, such as rental real estate activities. The subject will be discussed in more detail in Chapter 3.

C. OTHER NONPASSIVE INCOME

Generally, taxpayers can use losses from passive activities only to offset income from passive activities. Investors generally cannot use passive activity losses to offset other income, such as wages or portfolio income. Portfolio income includes gross income from interest, dividends, annuities, or royalties that is not derived in the ordinary course of a trade or business. It also includes gains or losses (not derived in the ordinary course of a trade or business) from the sale or trade of property (other than an interest in a passive activity) producing portfolio income or held for investment. This includes capital gain distributions from mutual funds and real estate investment trusts.

II. Interest Expenses

A. INVESTMENT INTEREST

If an individual borrows money to buy property to hold for investment, the interest the investor pays is investment interest. He or she can deduct investment interest subject to the limit discussed later. However, the investor cannot deduct interest incurred to produce tax-exempt income. Investment interest does not include any qualified home mortgage interest or any interest taken into account in computing income or loss from a passive activity.

B. INVESTMENT PROPERTY

Property held for investment includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes property that produces gain or loss (not derived in the ordinary course of a trade or business) from the sale or trade of property producing these types of income or held for investment (other than an interest in a passive activity). Investment property also includes an interest in a trade or business activity in which the investor did not materially participate (other than a passive activity).

1. Allocation of Interest Expense

If an individual borrows money for business or personal purposes as well as for investment, they must allocate the debt among those purposes. Only the interest expense on the part of the debt used for investment purposes is treated as investment interest. The allocation is not affected by the use of property that secures the debt.

Example 1.

Walt borrows \$10,000 and uses \$8,000 to buy stock. He uses the other \$2,000 to buy items for his home. Since 80% of the debt is used for, and allocated to, investment purposes, 80% of the interest on that debt is investment interest. The other 20% is nondeductible personal interest.

2. Debt Proceeds Received in Cash

If an investor receives debt proceeds in cash, the proceeds are generally not treated as investment property. If an investor deposits debt proceeds in an account, that deposit is treated as investment property, regardless of whether the account bears interest. But, if the individual withdraws the funds and uses them for another purpose, they must reallocate the debt to determine the amount considered to be for investment purposes.

Example 2.

Assume in Example 1 that Walt borrowed the money on March 1 and immediately bought the stock for \$8,000. Walt did not buy the household items until June 1. He had deposited the \$2,000 in the bank. Walt had no other transactions on the bank account and made no principal payments on the debt. The \$2,000 is treated as being used for an investment purpose for the 3-month period. Walt's total interest expense for 3 months on this debt is investment interest. In June, he must begin to allocate 80% of the debt and the interest expense to investment purposes and 20% to personal purposes.

3. Amounts Paid Within 30 Days

If an individual receives loan proceeds in cash or if the loan proceeds are deposited in an account, he or she can treat any payment (up to the amount of the proceeds) made from any account he or she owns, or from cash, as made from those proceeds. This applies to any payment made within 30 days before or after the proceeds are received in cash or deposited in their account.

If the individual received the loan proceeds in cash, they can treat the payment as made on the date they received the cash instead of the date they actually made the payment.

4. Pass-Through Entities

If an individual uses borrowed funds to buy an interest in a partnership or S corporation, then the interest on those funds must be allocated based on the assets of the entity. If the individual contributes to the capital of the entity, they can make the allocation using any reasonable method.

C. WHEN TO DEDUCT INVESTMENT INTEREST

If an investor uses the cash method of accounting, they must pay the interest before they can deduct it. If an individual uses an accrual method of accounting, they can deduct interest over the period it accrues, regardless of when it is paid.

Example.

Jack borrowed \$1,000 on September 6, 2007, payable in 90 days at 12% interest. On December 5, 2007, he paid this with a new note for \$1,030, due on March 5, 2008. If Jack uses the cash method of accounting, he cannot deduct any part of the \$30 interest on his return for 2007 because he did not actually pay it. If Jack uses an accrual method, he may be able to deduct a portion of the interest on the loans through December 31, 2007, on his return for 2007.

1. Interest Paid in Advance

Generally, if an individual pays interest in advance for a period that goes beyond the end of the tax year, they must spread the interest over the tax years to which it belongs under the OID rules. The individual can deduct in each year only the interest for that year.

2. Interest on Margin Accounts

If an individual is a cash method taxpayer, he or she can deduct interest on margin accounts to buy taxable securities as investment interest in the year he or she paid it. The investor is considered to have paid interest on these accounts only when he or she actually pays the broker or when payment becomes available to the broker through their account. Payment may become available to the broker through their account when the broker collects dividends or interest for the investor's account, or sells securities held for the investor or received from the investor. Investors cannot deduct any interest on money borrowed for personal reasons.

3. Deferral of Interest Deduction for Market Discount Bonds

The amount an individual can deduct for interest expense paid or accrued during the year to buy or carry a market discount bond may be limited. This limit does not apply if the individual accrues the market discount and includes it in their income currently.

III. Limits on Deductions

Generally, deductions for investment interest expense are limited to the amount of the investor's net investment income. Investors can carry over the amount of investment interest that they could not deduct because of this limit to the next tax year. The interest carried over is treated as investment interest paid or accrued in that next year.

Investors can carry over disallowed investment interest to the next tax year even if it is more than their taxable income in the year the interest was paid or accrued.

A. NET INVESTMENT INCOME

Investment income generally includes gross income from property held for investment (such as interest, dividends, annuities, and royalties). Investment income does not include Alaska Permanent Fund dividends.

Investment income generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds). However, investors can choose to include all or part of their net capital gain in investment income.

1. Net Capital Gain

If an investor chooses to include any amount of their net capital gain in investment income, they must reduce their net capital gain that is eligible for the lower capital gains tax rates by the same amount. Before making this choice, investors must consider the overall effect on their tax liability.

2. Investment Income of Child

Investment income includes the part of a child's interest and dividend income that an investor chooses to report on their return.

3. Investment Expenses

Investment expenses include all income-producing expenses (other than interest expense) relating to investment property that are allowable deductions after applying the 2% limit that applies to miscellaneous itemized deductions.

4. Losses from Passive Activities

Income or expenses that an investor used in computing income or loss from a passive activity are not included in determining their investment income or investment expenses (including investment interest expense).

Example.

Ted is a partner in a partnership that operates a business. However, he does not materially participate in the partnership's business. Ted's interest in the partnership is considered a passive activity.

Ted's investment income from interest and dividends is \$10,000. His investment expenses (other than interest) are \$3,200 after taking into account the 2% limit on miscellaneous itemized deductions. His investment interest expense is \$8,000. Ted also has income from the partnership of \$2,000.

Ted figures his net investment income and the limit on his investment interest expense deduction in the following way:

<i>Total Investment Income</i>	<i>\$10,000</i>
<i>Minus: Investment Expense (other than Interest)</i>	<i>\$3,200</i>
<i>Net Investment Income</i>	<i>\$6,800</i>
<i>Deductible investment interest expense For the year</i>	<i>\$6,800</i>

The \$2,000 of income from the passive activity is not used in determining Ted's net investment income. His investment interest deduction for the year is limited to \$6,800, the amount of his net investment income.

IV. Expenses of Producing Income

Individuals must deduct investment expenses (other than interest expenses) as miscellaneous itemized deductions on Schedule A (Form 1040). To be deductible, these expenses must be ordinary and necessary expenses paid or incurred:

- ❑ To produce or collect income, or
- ❑ To manage property held for producing income.

The expenses must be directly related to the income or income-producing property, and the income must be taxable to the investor.

The deduction for most income-producing expenses is subject to a 2% limit that also applies to certain other miscellaneous itemized deductions. The amount deductible is limited to the total of these miscellaneous deductions that is more than 2% of an individual's adjusted gross income.

A. TYPES OF EXPENSES

1. Attorney or Accounting Fees

Individuals can deduct attorney or accounting fees that are necessary to produce or collect taxable income. However, in some cases, attorney or accounting fees are part of the basis of property.

2. Automatic Investment Service and Dividend Reinvestment Plans

A bank may offer its checking account customers an automatic investment service so that, for a charge, each customer can choose to invest a part of the checking account each month in common stock. Or, a bank that is a dividend disbursing agent for a number of publicly-owned corporations may set up an automatic dividend reinvestment service. Through that service, cash dividends are reinvested in more shares of stock, after the bank deducts a service charge.

A corporation in which an individual owns stock also may have a dividend reinvestment plan. This plan lets individuals choose to use their dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash.

Individuals can deduct the monthly service charge they pay to a bank to participate in an automatic investment service. If they participate in a dividend reinvestment plan, they can deduct any service charge subtracted from their cash dividends before the dividends are used to buy more shares of stock. Individuals can deduct the charges in the year in which they are paid.

3. Clerical Help and Office Rent

Individuals can deduct office expenses, such as rent and clerical help, that are paid in connection with their investments and collecting the taxable income on them.

4. Cost of Replacing Missing Securities

To replace taxable securities that are misplaced, lost, stolen, or destroyed, individuals may have to post an indemnity bond. The individual can deduct the premium they pay to buy the indemnity bond and the related incidental expenses. The individual may, however, get a refund of part of the bond premium if the missing securities are recovered within a specified time. Under certain types of insurance policies, the person can recover some of the expenses.

If an individual receives the refund in the tax year they pay the amounts, they can deduct only the difference between the expenses paid and the amount refunded. If the refund is made in a later tax year, the individual must include the refund in income in the year it is received, but only to the extent that the expenses decreased the individual's tax in the year they were deducted.

5. Fees to Collect Income

Individuals can deduct fees paid to a broker, bank, trustee, or similar agent to collect investment income, such as their taxable bond or mortgage interest, or dividends on shares of stock. On the other hand, individuals cannot deduct a fee paid to a broker to acquire investment property, such as stocks or bonds. He or she must add the fee to the cost of the property.

Likewise, individuals cannot deduct any broker's fees, commissions, or option premiums paid (or that were netted out) in connection with the sale of investment property. They can be used only to figure gain or loss from the sale.

6. Investment Counsel and Advice

Individuals can deduct fees paid for counsel and advice about investments that produce taxable income. This includes amounts paid for investment advisory services.

7. Safe Deposit Box Rent

Individuals can deduct rent paid for a safe deposit box if it is used to store taxable income-producing stocks, bonds, or other investment-related papers and documents. If the box is also used to store tax-exempt securities or personal items, only part of the rent can be deducted.

8. State and Local Transfer Taxes

Individuals cannot deduct the state and local transfer taxes paid when securities are bought and sold. If an individual pays these transfer taxes when securities are purchased, they must be treated as part of the cost of the property. If the transfer taxes are paid when the securities are sold, they must be treated as a reduction in the amount realized.

9. Trustee's Commissions for Revocable Trust

If an individual sets up a revocable trust and has its income distributed, he or she can deduct the commission paid to the trustee for managing the trust to the extent it is to produce or collect taxable income or to manage property. However, the individual cannot deduct any part of the commission that is for producing or collecting tax-exempt income or for managing property that produces tax-exempt income.

If the individual is a cash-basis taxpayer and pays the commissions for several years in advance, he must deduct a part of the commission each year. He cannot deduct the entire amount in the year it is paid.

10. Investment Expenses from Pass-Through Entities

If an individual holds an interest in a partnership, S corporation, real estate mortgage investment conduit (REMIC), or a nonpublicly offered regulated investment company (mutual fund), they can deduct their share of that entity's investment expenses.

An individual's share of the investment expenses of a REMIC or a nonpublicly offered mutual fund, as described above, are considered to be indirect deductions through that pass-through entity. Individuals must include in their gross income an amount equal to the amount of the expenses allocated to that individual, whether or not they are able to claim a deduction for those expenses. If the individual is a shareholder in a nonpublicly offered mutual fund, he must include on his return the full amount of ordinary dividends or other distributions of stock. If an individual is a residual interest holder in a REMIC, he must report as ordinary income.

B. NONDEDUCTIBLE EXPENSES

Some expenses that individuals incur as an investor are not deductible, including the following.

1. Stockholders' Meetings

Individuals cannot deduct transportation and other expenses that are paid to attend stockholders' meetings of companies in which the individual has no interest other than owning stock. This is true even if the person's purpose in attending is to get information that would be useful in making further investments.

2. Investment-Related Seminars

Individuals cannot deduct expenses for attending a convention, seminar, or similar meeting for investment purposes.

3. Single-Premium Life Insurance, Endowment, and Annuity Contracts

Individuals cannot deduct interest on money they borrow to buy or carry a single-premium life insurance, endowment, or annuity contract.

4. Borrowing on Insurance

Generally, individuals cannot deduct interest on money borrowed to buy or carry a life insurance, endowment, or annuity contract if the individual plans to systematically borrow part or all of the increases in the cash value of the contract. This rule applies to the interest on the total amount borrowed to buy or carry the contract, not just the interest on the borrowed increases in cash value.

5. Tax-Exempt Income

Individuals cannot deduct expenses incurred to produce tax-exempt income. Nor can individuals deduct interest on money borrowed to buy tax-exempt securities or shares in a regulated investment company (mutual fund) that distributes only exempt-interest dividends.

The rule disallowing a deduction for interest expenses on tax-exempt securities applies to amounts paid in connection with personal property used in a short sale or amounts paid by others for the use of any collateral in connection with the short sale. However, it does not apply to the expenses incurred when the person deposits cash as collateral for the property used in the short sale and the cash does not earn a material return during the period of the sale.

Individuals may have expenses that are for both tax-exempt and taxable income. If they cannot specifically identify what part of the expenses is for each type of income, they can divide the expenses, using reasonable proportions based on facts and circumstances. The individual must attach a statement to their return showing how the expenses were divided and stating that each deduction claimed is not based on tax-exempt income.

One accepted method for dividing expenses is to do it in the same proportion that each type of income is to the total income. If the expenses relate in part to capital gains and losses, they can include the gains, but not the losses, in figuring this proportion. To find the part of the expenses that is for the tax-exempt income, an individual should tax-exempt income by the total income and multiply their expenses by the result.

Example.

Martin received \$6,000 interest; \$4,800 was tax-exempt and \$1,200 was taxable. In earning this income, Martin had \$500 of expenses. He cannot specifically identify the amount of each expense item that is for each income item, so he must divide his expenses. 80% (\$4,800 tax-exempt interest divided by \$6,000 total interest) of his expenses is for the tax-exempt income. Martin cannot deduct \$400 (80% of \$500) of the expenses. Martin can deduct \$100 (the rest of the expenses) because they are for the taxable interest.

6. State Income Taxes

If an individual itemizes his deductions, he can deduct as taxes, state income taxes on interest income that is exempt from federal income tax. But he cannot deduct, as either taxes or investment expenses, state income taxes on other exempt income.

7. Interest Expense and Carrying Charges on Straddles

Individuals cannot deduct interest and carrying charges that are allocable to personal property that is part of a straddle. The nondeductible interest and carrying charges are added to the basis of the straddle property. However, this treatment does not apply if:

- ❑ All the offsetting positions making up the straddle either consist of one or more qualified covered call options and the optioned stock or consist of section 1256 contracts (and the straddle is not part of a larger straddle), or
- ❑ The straddle is a hedging transaction.

C. WHEN TO REPORT INVESTMENT EXPENSES

If an investor uses the cash method to report income and expenses, he or she can generally deduct their expenses, except for certain prepaid interest, in the year in which they are paid.

If the individual uses an accrual method, they generally deduct their expenses when they incur a liability for them, rather than when they are paid.

CHAPTER 2 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following statements best describes the “at risk” rule:
 - a) the amount of money a taxpayer can deduct is limited by the amount they have “at risk”
 - b) people who are afraid to invest rarely make much money
 - c) people who risk more are entitled to more tax deductions
 - d) none of the above
2. If an investor uses the accrual method of accounting, they must pay interest before it can be deducted.
 - a) true
 - b) false
3. What is the limit placed on the deduction of income-producing expenses:
 - a) there is no limitation whatsoever
 - b) the amount that is deductible is subject to a 2% limit
 - c) the amount that is deductible is subject to an 8% limit
 - d) the amount that is deductible is limited to no more than 10% of the taxpayer’s AGI
4. The cost of renting a safe deposit box is never deductible.
 - a) true
 - b) false
5. Which of the following expenses is not tax-deductible:
 - a) the cost of attending a shareholders’ meeting
 - b) the cost of attending an investment seminar
 - c) both of the above
 - d) neither of the above

CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** The at risk rules generally limit the amount that an investor can deduct from their taxes to the amount they actually have “at risk.”

B: Incorrect. This may be true but it is not the meaning of this rule.

C: Incorrect. This is not the meaning or intent of the rule.

D: Incorrect. One of the responses is the correct description of the rule.

(See pages 2-1 to 2-2 of the course material.)

2. A: True is incorrect. If an investor uses the accrual method of accounting, they can deduct it over the period in which it accrues, regardless of when it is actually paid.

B: False is correct. If an investor uses the cash method of accounting, they must pay the interest before it can be deducted.

(See page 2-3 of the course material.)

3. A: Incorrect. There is a limit on the amount of these expenses that can be deducted.

B: Correct. The amount deductible is limited to more than 2% of an individual's adjusted gross income.

C: Incorrect. The limit is actually less than 8%.

D: Incorrect. The limit is the same as that of certain other miscellaneous itemized deductions.

(See page 2-6 of the course material.)

4. A: True is incorrect. Under some circumstances, the cost is deductible.

B: False is correct. Individuals can deduct rent paid for a safe deposit box if it is used to store taxable income-producing stocks, bonds, or other investment-related papers and documents. If the box is also used to store tax-exempt securities or personal items, only part of the rent can be deducted.

(See page 2-7 of the course material.)

5. A: Incorrect. Investors can deduct a number of expenses. However, the cost of attending a shareholders' meeting, even to research a potential investment, is not one of them.

B: Incorrect. No different than the cost of a business degree, seminar costs are not deductible even if they are aimed at making money.

C: Correct. Neither of these expenses are tax deductible, even if their intent is to make the taxpayer money.

D: Incorrect. Neither expense is tax deductible.

(See page 2-8 of the course material.)

Chapter 3: Passive and At-Risk Rules

There are many factors that must be taken into account when an individual makes a particular investment decision. For individuals considering certain types of investments as part of their financial plan, it is important to recognize certain tax implications that could reduce the value of particular types of investments. For example, if William decides to invest in a shopping center in hopes of using the money to pay for his children's education in later years, what are the implications if the project loses money? Will he be able to deduct all of those losses against other income? The passive activity limitations and at-risk rules can have a significant affect on the tax implications of certain types of investments, and therefore, must be understood before crafting a financial plan.

I. Passive Activity Limitations

Passive income and at-risk rules affect the losses that a taxpayer can use to offset income from other sources, such as capital gains on the sale of stocks or bonds. In general, taxpayers can deduct passive activity losses only from passive activity income. Taxpayers carry any excess loss forward to the following year or years until used, or until deducted in the year they dispose of their entire interest in the activity in a fully taxable transaction. Before applying this limit on passive activity losses, a taxpayer must first determine the amount of their loss disallowed under the at-risk rules, explained later in this chapter.

A. PERSONS SUBJECT TO RULES

The passive activity rules apply to:

- ☐ Individuals;
- ☐ Estates;
- ☐ Trusts (other than grantor trusts);
- ☐ Personal service corporations; and
- ☐ Closely held corporations.

Even though the rules do not apply to grantor trusts, partnerships, or S corporations directly, they do apply to the owners of these entities.

B. PASSIVE ACTIVITIES

1. Types of Activities

There are two kinds of passive activities:

- ☐ Trade or business activities in which individuals do not materially participate during the year; and

- ❑ Rental activities, even if the individual does materially participate in them, unless they are a real estate professional.

2. Former Passive Activities

A former passive activity is an activity that was a passive activity in any earlier tax year, but is not a passive activity in the current tax year. A taxpayer can deduct a prior years' disallowed loss from the activity up to the amount of their current year net income from the activity. Any remaining prior year disallowed loss should be treated like any other passive loss.

In addition, any prior year disallowed passive activity credits from a former passive activity offsets the allocable part of a taxpayer's current year tax liability. The allocable part of a taxpayer's current year tax liability is that part of this year's tax liability that is allocable to the current year net income from the former passive activity.

3. Trade or Business Activities

A trade or business activity is an activity that:

- ❑ Involves the conduct of a trade or business (that is, deductions would be allowable under § 162 of the Internal Revenue Code if other limitations, such as the passive activity rules, did not apply);
- ❑ Is conducted in anticipation of starting a trade or business; or
- ❑ Involves research or experimental expenditures that are deductible under Internal Revenue Code § 174 (or that would be deductible if they chose to deduct rather than capitalize them).

A trade or business activity does not include a rental activity or the rental of property that is incidental to an activity of holding the property for investment.

4. Rental Activities

A rental activity is a passive activity even if an individual materially participated in that activity, unless they materially participated as a real estate professional. An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It does not matter whether the use is under a lease, a service contract, or some other arrangement.

An activity is not a rental activity if any of the following apply:

- ❑ The average period of customer use of the property is seven days or less. The average period of customer use is calculated by dividing the total number of days in all rental periods by the number of rentals during the tax year. If the activity involves renting more than one class of property, multiply the average period of customer use of each class by a fraction. The numerator of the fraction is the gross rental income from that class of property and the denominator is the activity's total gross rental income. The activity's average period of customer use will equal the sum of the amounts for each class;

- ❑ The average period of customer use of the property, as figured above, is 30 days or less and the individual provides significant personal services with the rentals. Significant personal services include only services performed by individuals. To determine if personal services are significant, all relevant facts and circumstances are taken into consideration, including the frequency of the services, the type and amount of labor required to perform the services, and the value of the services relative to the amount charged for use of the property. Significant personal services do not include the following:
 - Services needed to permit the lawful use of the property;
 - Services to repair or improve property that would extend its useful life for a period substantially longer than the average rental; and
 - Services that are similar to those commonly provided with long-term rentals of real estate, such as cleaning and maintenance of common areas or routine repairs.
- ❑ An individual provides extraordinary personal services in making the rental property available for customer use. Services are extraordinary personal services if they are performed by individuals and the customers' use of the property is incidental to their receipt of the services;
- ❑ The rental is incidental to a non-rental activity. The rental of property is incidental to an activity of holding property for investment if the main purpose of holding the property is to realize a gain from its appreciation and the gross rental income from the property is less than 2% of the smaller of the property's unadjusted basis or fair market value. The unadjusted basis of property is its cost not reduced by depreciation or any other basis adjustment. The rental of property is incidental to a trade or business activity if all of the following apply:
 - An individual owns an interest in the trade or business activity during the year;
 - The rental property was used mainly in that trade or business activity during the current year, or during at least 2 of the 5 preceding tax years;
 - The individual's gross rental income from the property is less than 2% of the smaller of its unadjusted basis or fair market value. Lodging provided to an employee or the employee's spouse or dependents is incidental to the activity or activities in which the employee performs services if the lodging is furnished for the employer's convenience.
- ❑ The individual customarily make the rental property available during defined business hours for nonexclusive use by various customers; or

- ❑ The individual provides the property for use in a non-rental activity in their capacity as an owner of an interest in the partnership, S corporation, or joint venture conducting that activity.

If an individual meets any of the exceptions listed above, see the instructions for Form 8582 for information about how to report any income or loss from the activity.

If a taxpayer or their spouse actively participated in a passive rental real estate activity, they can deduct up to \$25,000 of loss from the activity from their non-passive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, an individual can offset credits from the activity against the tax on up to \$25,000 of non-passive income after taking into account any losses allowed under this exception.

If a taxpayer is married, filing a separate return, and lived apart from their spouse for the entire tax year, their special allowance cannot be more than \$12,500. If an individual lived with their spouse at any time during the year and is filing a separate return, they cannot use the special allowance to reduce their non-passive income or tax on non-passive income. The maximum special allowance is reduced if an individual's modified adjusted gross income exceeds certain amounts.

Example.

Kate, a single taxpayer, has \$70,000 in wages, \$15,000 income from a limited partnership, a \$26,000 loss from rental real estate activities in which she actively participated, and less than \$100,000 of modified adjusted gross income. She can use \$15,000 of her \$26,000 loss to offset her \$15,000 passive income from the partnership. She actively participated in her rental real estate activities, so she can use the remaining \$11,000 rental real estate loss to offset \$11,000 of her non-passive income (wages).

5. Active Participation

Active participation is a less stringent standard than material participation. For example, an individual may be treated as actively participating if they make management decisions in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Only individuals can actively participate in rental real estate activities. However, a decedent's estate is treated as actively participating for its tax years ending less than 2 years after the decedent's death, if the decedent would have satisfied the active participation requirement for the activity for the tax year the decedent died. A decedent's qualified revocable trust can also be treated as actively participating if both the trustee and the executor (if any) of the estate choose to treat the trust as part of the estate. The choice applies to tax years ending after the decedent's death and before:

- ❑ Two years after the decedent's death if no estate tax return is required; or
- ❑ Six months after the estate tax liability is finally determined if an estate tax return is required.

The choice is irrevocable and cannot be made later than the due date for the estate's first income tax return (including any extensions). Limited partners are not treated as actively participating in a partnership's rental real estate activities.

An individual is not treated as actively participating in a rental real estate activity unless their interest in the activity (including a spouse's interest) was at least 10% (by value) of all interests in the activity throughout the year. Active participation is not required to take the low-income housing credit, the rehabilitation investment credit, or commercial revitalization deduction from rental real estate activities.

Example.

Mike, a single taxpayer, had the following income and loss during the tax year:

Salary	\$42,300
Dividends	300
Interest	1,400
Rental loss	(4,000)

The rental loss came from a house Mike owned. He advertised and rented the house to the current tenant himself. He also collected the rents and either did the repairs or hired someone to do them. Even though the rental loss is a loss from a passive activity, Mike can use the entire \$4,000 loss to offset his other income because he actively participated.

6. Phaseout Rule

The maximum special allowance of \$25,000 (\$12,500 for married individuals filing separate returns and living apart at all times during the year) is reduced by 50% of the amount of an individual's modified adjusted gross income that is more than \$100,000 (\$50,000 if a taxpayer is married filing separately). If a taxpayer's modified adjusted gross income is \$150,000 or more (\$75,000 or more if they are married filing separately) they generally cannot use the special allowance.

Modified adjusted gross income for this purpose is an individual's adjusted gross income figured without the following:

- ❑ Taxable social security and tier 1 railroad retirement benefits;
- ❑ Deductible contributions to individual retirement accounts (IRAs) and § 501(c)(18) pension plans;
- ❑ The exclusion from income of interest from qualified U.S. savings bonds used to pay qualified higher education expenses;

- ❑ The exclusion from income of amounts received from an employer's adoption assistance program;
- ❑ Passive activity income or loss included on Form 8582;
- ❑ Any rental real estate loss allowed because you materially participated in the rental activity as a real estate professional;
- ❑ Any overall loss from a publicly traded partnership;
- ❑ The deduction for one-half of self-employment tax;
- ❑ The deduction allowed for interest on student loans; or
- ❑ The deduction for qualified tuition and related expenses.

Example.

During 2007, John was unmarried and was not a real estate professional. For 2007, he had \$120,000 in salary and a \$31,000 loss from his rental real estate activities in which he actively participated. His modified adjusted gross income is \$120,000. When he files his 2007 return, he may deduct only \$15,000 of his passive activity loss. He must carry over the remaining \$16,000 passive activity loss to 2008. He figures his deduction and carryover as follows:

<i>Adjusted gross income, modified as required</i>	\$120,000
<i>Minus amount not subject to phaseout</i>	<u>100,000</u>
<i>Amount subject to phaseout rule</i>	\$20,000
<i>Multiply by 50%</i>	<u>× 50%</u>
<i>Required reduction to special allowance</i>	<u>\$10,000</u>
<i>Maximum special allowance</i>	\$25,000
<i>Minus required reduction (see above)</i>	<u>10,000</u>
<i>Adjusted special allowance</i>	<u>\$15,000</u>
<i>Passive loss from rental real estate</i>	\$31,000
<i>Deduction allowable/Adjusted special allowance (see above)</i>	<u>15,000</u>
<i>Amount that must be carried forward</i>	<u>\$16,000</u>

A higher phaseout range applies to low-income housing credits for property placed in service before 1990 and rehabilitation investment credits from rental real estate activities. For those credits, the phaseout of the \$25,000 special allowance starts when a taxpayer's modified adjusted gross income exceeds \$200,000 (\$100,000 if the taxpayer is a married individual filing a separate return and living apart at all times during the year).

There is no phaseout of the \$25,000 special allowance for low-income housing credits for property placed in service after 1989 or for the commercial revitalization deduction. If an individual holds an indirect interest in the property through a partnership, S corporation, or other pass-through entity, the special exception for the low-income housing credit will not apply unless they also acquired their interest in the pass-through entity after 1989.

If a taxpayer has more than one of the exceptions to the phaseout rules in the same tax year, they must apply the \$25,000 phaseout against their passive activity losses and credits in the following order:

- ❑ The portion of passive activity losses not attributable to the commercial revitalization deduction;
- ❑ The portion of passive activity losses attributable to the commercial revitalization deduction;
- ❑ The portion of passive activity credits attributable to credits other than the rehabilitation and low-income housing credits;
- ❑ The portion of passive activity credits attributable to the rehabilitation credit and low-income housing credit for property placed in service prior to 1990; and
- ❑ The portion of passive activity credits attributable to the low-income housing credit for property placed in service after 1989.

C. ACTIVITIES THAT ARE NOT PASSIVE

The following are not passive activities:

- ❑ Trade or business activities in which an individual materially participates for the tax year;
- ❑ A working interest in an oil or gas well held directly or through an entity that does not limit the investor's liability (such as a general partner interest in a partnership). It does not matter whether the individual materially participated in the activity for the tax year. However, if the individual's liability was limited for part of the year (for example, they converted their general partner interest to a limited partner interest during the year) and they had a net loss from the well for the year, some of their income and deductions from the working interest may be treated as passive activity gross income and passive activity deductions;
- ❑ The rental of a dwelling unit that an individual also used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental;
- ❑ An activity of trading personal property for the account of those who own interests in the activity; or
- ❑ Rental real estate activities in which an individual materially participated as a real estate professional.

1. Material Participation

A trade or business activity is not a passive activity if an individual materially participated in the activity. An individual is considered to have materially participated in a trade or business activity for a tax year if they satisfy any of the following tests:

- ❑ They participated in the activity for more than 500 hours;
- ❑ Their participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity;
- ❑ They participated in the activity for more than 100 hours during the tax year, and participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year;
- ❑ The activity is a significant participation activity, and the individual participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which an individual participated for more than 100 hours during the year and in which they did not materially participate under any of the material participation tests, other than this test;
- ❑ The individual materially participated in the activity for any five (whether or not consecutive) of the ten immediately preceding tax years;
- ❑ The activity is a personal service activity in which the individual materially participated for any three (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor; or
- ❑ Based on all the facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during the year.

An individual did not materially participate in the activity under the last test if they participated in the activity for 100 hours or less during the year. An individual's participation in managing the activity does not count in determining whether they materially participated under this test if:

- ❑ Any other person received compensation for managing the activity; or
- ❑ Any other person spent more hours than the individual during the tax year managing the activity (regardless of whether the individual was compensated for the management services).

In general, any work an individual does in connection with an activity in which they own an interest is treated as participation in the activity. A taxpayer may not treat the work

they do in connection with an activity as participation in the activity if both of the following are true:

- ❑ The work is not work that is customarily done by the owner of that type of activity; and
- ❑ One of their main reasons for doing the work is to avoid the disallowance of any loss or credit from the activity under the passive activity rules.

An investor is generally not actively participating in a business unless they are directly involved in the day-to-day operations of the enterprise. Work conducted by an investor generally includes:

- ❑ Studying and reviewing financial statements or reports on operations of the activity;
- ❑ Preparing or compiling summaries or analyses of the finances or operations of the activity for their own use; and
- ❑ Monitoring the finances or operations of the activity in a nonmanagerial capacity.

An individual's participation in an activity includes their spouse's participation. This applies even if the spouse did not own any interest in the activity and the couple did not file a joint return for the tax year in question.

Taxpayers can generally use any reasonable method to prove their participation in an activity for the year. It is not necessary to keep contemporaneous daily time reports, logs, or similar documents if an individual can establish their participation in some other way. For example, individuals can show the services they performed and the approximate number of hours spent by using an appointment book, calendar, or narrative summary.

2. Limited Partners

If an individual was a part owner of a business as a limited partner, they generally are not treated as materially participating in the activity. However, they can be considered to have materially participated if they meet any of the tests discussed above. Limited partners concerned about passive income should note, however, that their active participation in the management or operations of the business could jeopardize their limited liability status and therefore expose them to personal liability for the debts and obligations of the company.

3. Corporations

A closely held corporation or a personal service corporation is treated as materially participating in an activity only if one or more shareholders holding more than 50% by value of the outstanding stock of the corporation materially participated in the activity.

D. PASSIVE ACTIVITY CREDITS

Taxpayers can subtract passive activity credits only from the tax on net passive income. Passive activity credits include the general business credit and other special business credits, such as the credit for fuel produced from a nonconventional source. Credits that are more than the tax on income from passive activities are carried forward.

Unallowed passive activity credits, unlike unallowed passive activity losses, cannot be claimed when a taxpayer disposes of their entire interest in an activity. However, to determine a taxpayer's gain or loss from the disposition, they can elect to increase the basis of the credit property by the amount of the original basis reduction for the credit, to the extent that the credit was not allowed because of the passive activity limits. A taxpayer cannot elect to adjust the basis for a partial disposition of their interest in a passive activity.

II. At-Risk Rules

The at-risk rules limit the losses from most activities to the amount an individual has at risk in the activity. Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year. If a taxpayer's losses from an at-risk activity are allowed, they are subject to recapture in later years if the individual's amount at risk is reduced below zero. The at-risk rules must be applied before the passive activity rules discussed in the previous section.

A. ACTIVITIES COVERED BY THE AT-RISK RULES

Persons involved in one of the following activities as a trade or business or for the production of income are subject to the at-risk rules:

- ☐ Holding, producing, or distributing motion picture films or video tapes;
- ☐ Farming;
- ☐ Leasing § 1245 property, including personal property and certain other tangible property that is depreciable or amortizable;
- ☐ Exploring for, or exploiting, oil and gas;
- ☐ Exploring for, or exploiting, geothermal deposits (for wells started after September 1978); or
- ☐ Any other activity that is carried on as a trade or business or for the production of income.

1. Section 1245 Property

Section 1245 property includes any property that is or has been subject to depreciation or amortization and is:

- ☐ Personal property;

- ❑ Other tangible property (other than a building or its structural components) that is:
 - Used in manufacturing, production, extraction or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services;
 - A research facility;
 - A facility used in any of the activities for the bulk storage of fungible commodities;
 - A single purpose agricultural or horticultural structure; or
 - A storage facility (other than a building or its structural components) used for the distribution of petroleum.

2. Exception for Holding Real Property Placed in Service Before 1987

The at-risk rules do not apply to the holding of real property placed in service before 1987. They also do not apply to the holding of an interest acquired before 1987 in a pass-through entity engaged in holding real property placed in service before 1987. This exception does not apply to holding mineral property.

Personal property and services that are incidental to making real property available as living accommodations are included in the activity of holding real property. For example, making personal property, such as furniture, and services available when renting a hotel or motel room or a furnished apartment is considered incidental to making real property available as living accommodations.

3. Exception for Equipment Leasing by a Closely Held Corporation

If a closely held corporation is actively engaged in equipment leasing, the equipment leasing is treated as a separate activity not covered by the at-risk rules. A closely held corporation is actively engaged in equipment leasing if 50% or more of its gross receipts for the tax year are from equipment leasing. Equipment leasing means the leasing, purchasing, servicing, and selling of equipment that is § 1245 property.

However, equipment leasing does not include the leasing of master sound recordings and similar contractual arrangements for tangible or intangible assets associated with literary, artistic, or musical properties, such as books, lithographs of artwork, or musical tapes. A closely held corporation cannot exclude these leasing activities from the at-risk rules nor count them as equipment leasing for the gross receipts test.

The equipment leasing exclusion also is not available for leasing activities related to other at-risk activities, such as motion picture films and video tapes, farming, oil and gas properties, and geothermal deposits. For example, if a closely held corporation leases a video tape, it cannot exclude this leasing activity from the at-risk rules under the equipment leasing exclusion.

4. Special Exception for Qualified Corporations

A qualified corporation is not subject to the at-risk limits for any qualifying business carried on by the corporation. Each qualifying business is treated as a separate activity. A qualified corporation is a closely held corporation, defined earlier, that is not:

- ❑ A personal holding company;
- ❑ A foreign personal holding company; or
- ❑ A personal service corporation.

B. "LOSS" DEFINED

A "loss" is the excess of allowable deductions from the activity for the year (including depreciation or amortization allowed or allowable and disregarding the at-risk limits) over income received or accrued from the activity during the year. Income does not include income from the recapture of previous losses.

IRS Form 6198 is used to figure how much loss from an activity can be deducted. The form must be filed with a tax return if a taxpayer has a loss from any part of an activity that is covered by the at-risk rules, and the individual is not at risk for some of their investment in the activity.

C. WHO IS AFFECTED

The at-risk limits apply to individuals (including partners and S corporation shareholders), estates, trusts, and certain closely held corporations (other than S corporations).

For the at-risk rules, a corporation is a closely held corporation if at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned directly or indirectly by or for five or fewer individuals. To determine whether more than 50% in value of the stock is owned by five or fewer individuals, apply the following rules:

1. Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries;
2. An individual is considered to own the stock directly or indirectly by or for his or her family;
3. Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants; and
4. If a person holds an option to buy stock, he or she is considered to be the owner of that stock.

When applying the first two rules, stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person. Stock considered owned by an individual under rule (2) is not treated as owned by the individual for again applying rule (2) to

consider another the owner of that stock. Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

D. AT-RISK AMOUNTS

An individual is considered at risk in any activity for:

- ❑ The money and adjusted basis of property they contribute to the activity; and
- ❑ Amounts they borrow for use in the activity if:
 - They are personally liable for repayment, or
 - They pledge property (other than property used in the activity) as security for the loan.

1. Amounts Borrowed

An individual is considered at risk for amounts borrowed to use in the activity if they are personally liable for repayment. An individual is also at risk if the amounts borrowed are secured by property other than property used in the activity. In this case, the amount considered at risk is the net fair market value of the individual's interest in the pledged property. The net fair market value of property is its fair market value (determined on the date the property is pledged) less any prior (or superior) claims to which it is subject. However, no property will be taken into account as security if it is directly or indirectly financed by debt that is secured by property the individual contributed to the activity.

If an individual borrows money to finance a contribution to an activity, they cannot increase the amount at risk by the contribution and the amount borrowed to finance the contribution. A taxpayer may increase their at-risk amount only once.

Even if an individual is personally liable for the repayment of a borrowed amount or they secure a borrowed amount with property other than property used in the activity, they are not considered at risk if they borrowed the money from a person having an interest in the activity or from someone related to a person having an interest in the activity. This does not apply to:

- ❑ Amounts borrowed by a corporation from its shareholders; or
- ❑ Amounts borrowed from a person having an interest in the activity as a creditor.

E. AMOUNTS NOT AT RISK

1. Nonrecourse Financing

An individual is not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Nonrecourse financing is financing for which an individual is not personally liable. If an individual borrows money to contribute to an activity and the lender's only recourse is to their interest in the activity or the property used in the activity, the loan is a nonrecourse loan.

An individual is not considered at risk for their share of any nonrecourse loan used to finance an activity or to acquire property used in the activity unless the loan is secured by property not used in the activity. However, an individual is considered at risk for qualified nonrecourse financing secured by real property used in an activity of holding real property.

Qualified nonrecourse financing is financing for which no one is personally liable for repayment and that is:

- ❑ Borrowed in connection with the activity of holding real property;
- ❑ Secured by real property used in the activity;
- ❑ Not convertible from a debt obligation to an ownership interest; and
- ❑ Loaned or guaranteed by any federal, state, or local government, or borrowed from a qualified person.

The rules below apply to any financing incurred after August 3, 1998. Individuals can also choose to apply these rules to financing obtained before August 4, 1998. If an individual elects to do this, they must reduce the amounts at risk as a result of applying these rules to years ending before August 4, 1998, to the extent they increase the losses allowed for those years.

In determining whether qualified nonrecourse financing is secured only by real property used in the activity of holding real property, disregard property that is incidental to the activity of holding real property. Also disregard other property if the total gross fair market value of that property is less than 10% of the total gross fair market value of all the property securing the financing.

For this purpose, an individual should treat themselves as owning directly their proportional share of the assets in any partnership in which they own, directly or indirectly, an equity interest.

A qualified person is a person who actively and regularly engages in the business of lending money. The most common example is a bank.

2. Capital Contribution

Any capital an individual contributed to an activity is not at risk if they are protected against economic loss by an agreement or arrangement for compensation or reimbursement. For example, an individual is not at risk if they will be reimbursed for part or all of any loss because of a binding agreement between themselves and another person.

Example 1.

Some commercial feedlots reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such stop loss orders, the investor is at risk only for the portion of the investor's capital for which the investor is not entitled to a reimbursement.

Example 2.

Bill is personally liable for a mortgage, but he separately obtains insurance to compensate him for any payments he must actually make because of his personal liability. Bill is considered at risk only to the extent of the uninsured portion of the personal liability to which he is exposed. He can include in the amount he has at risk the amount of any premium he paid from his personal assets for the insurance. However, if Bill obtains casualty insurance or insurance protecting himself against tort liability, it does not affect the amount he is otherwise considered to have at risk.

3. Reductions of Amounts At Risk

The amount an individual has at risk in any activity is reduced by any losses allowed in previous years under the at-risk rules. It may also be reduced because of distributions an individual received from the activity, debts changed from recourse to nonrecourse, or the initiation of a stop loss or similar agreement. If the amount at risk is reduced below zero, the individual's previously allowed losses are subject to recapture, as explained next.

4. Recapture Rule

If the amount an individual has at risk in any activity at the end of any tax year is less than zero, they must recapture at least part of their previously allowed losses. This is done by adding to their income from the activity for that year the lesser of the following amounts:

- ❑ The negative at-risk amount (treated as a positive amount); or
- ❑ The total amount of losses deducted in previous tax years beginning after 1978, minus any amounts the individual previously added to their income from that activity under this recapture rule.

CHAPTER 3 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Passive activity losses can be:
 - a) offset against any type of gains
 - b) offset only against passive activity gains
 - c) carried over if there is an insufficient amount of passive activity income against which to offset the losses
 - d) both b and c above
2. Income from rental activities is considered passive for federal tax purposes unless:
 - a) the tenant(s) does not have a long-term lease
 - b) the taxpayer participated in the investment as a real estate professional
 - c) the taxpayer owns at least five properties
 - d) the rental income is a significant part of the taxpayer's total income
3. Which of the following people will be considered to have "materially" participated in a business for the tax year:
 - a) Bill, who co-owned a consulting business in which he worked an average of 15 hours per week cultivating new business
 - b) Thomas, a shareholder in a closely-held corporation that produced electronic equipment at which he attended monthly management meetings but did little more
 - c) Mike, co-owner of a software development company who, along with his partner and the only other owner of the business, worked about five hours per week on the company
 - d) both a and c above
4. The at-risk rules limit the losses from most activities to the amount an individual has "at risk" in the activity:
 - a) true
 - b) false

CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Federal law limits the offset of passive activity losses to be offset only against passive activity income.

B: Incorrect. While this is true, this is not the best answer.

C: Incorrect. To the extent there is insufficient passive activity income against which to offset passive activity losses, it can be carried forward. However, this is not the most accurate answer.

D: Correct. Both B and C are correct. Passive activity losses can only be offset against passive activity income. However, excess losses can be carried forward to subsequent tax years.

(See page 3-1 of the course material.)

2. A: Incorrect. There is no affect of whether a lease is short or long term, or whether there is a lease at all, on whether income is considered to be from an active or a passive activity.

B: Correct. Unless the taxpayer acted as a professional in the transaction, i.e., he used his real estate license to acquire the property, rents and other income are considered passive.

C: Incorrect. The income is passive in this case regardless of the number of properties owned by the taxpayer unless he or she was involved as a real estate professional.

D: Incorrect. This factor does not make the income active, rather than passive.

(See page 3-2 of the course material.)

3. **A: Correct.** In this case, Bill participated for more than 500 hours during the year in active management of the business, and therefore his income from the business would not be classified as passive. The other men do not meet the test.

B: Incorrect. Even regular attendance at meetings is not sufficient given the relatively small amount of time he devoted to the activity.

C: Incorrect. Since neither partner put significant time into the business, it will be considered passive participation since the firm has employees putting in significantly more time.

D: Incorrect. Only A is considered to have active or material involvement.

(See page 3-8 of the course material.)

4. **A: True is correct.** Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year.

B: False is incorrect. If your losses from an at-risk activity are allowed, they are subject to recapture in later years if your amount "at risk" is reduced below zero.

(See page 3-10 of the course material.)

Chapter 4: Basis of Investment Property

I. Basis of Investment Property

Basis is a way of measuring an individual's investment in property for tax purposes. Individuals must know the tax basis of their property to determine whether they have a gain or loss on its sale or other disposition. Investment property normally has an original basis equal to its cost. If an individual gets property in some way other than buying it, such as by gift or inheritance, its fair market value may be important in figuring the basis.

A. COST BASIS

The basis of property an investor buys is usually its cost. The cost is the amount paid in cash, debt obligations, or other property or services.

1. Unstated Interest

If an individual buys property on a time-payment plan that charges little or no interest, the basis of the property is the stated purchase price, minus the amount considered to be unstated interest. An individual generally has unstated interest if their interest rate is less than the applicable federal rate.

2. Basis Other Than Cost

There are times when an individual must use a basis other than cost. In these cases, they may need to know the property's fair market value or the adjusted basis of the previous owner.

3. Fair Market Value

This is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts. Sales of similar property, around the same date, may be helpful in figuring fair market value.

B. PROPERTY RECEIVED FOR SERVICES

If an individual receives investment property for services, they must include the property's fair market value in income. The amount included in income then becomes the basis in the property. If the services were performed for a price that was agreed to beforehand, this price will be accepted as the fair market value of the property if there is no evidence to the contrary.

If an individual receives, as payment for services, property that is subject to certain restrictions, their basis in the property generally is its fair market value when it becomes substantially vested. Property becomes substantially vested when it is transferable or is no longer subject to substantial risk of forfeiture, whichever happens first.

If an individual buys investment property at less than fair market value, as payment for services, they must include the difference in income. The person's basis in the property is the price they pay plus the amount they include in income.

If investment property is received in trade for other property, the basis of the new property is its fair market value at the time of the trade unless the individual received the property in a nontaxable trade.

Example.

Rich trades A Company stock for B Company stock having a fair market value of \$1,200. If the adjusted basis of the A Company stock is less than \$1,200, Rich has a taxable gain on the trade. If the adjusted basis of the A company stock is more than \$1,200, Rich has a deductible loss on the trade. The basis of his B Company stock is \$1,200. If he later sells the B Company stock for \$1,300, Rich will have a gain of \$100.

1. Property Received in Nontaxable Trades

If an investor has a nontaxable trade, they do not recognize gain or loss until they dispose of the property they received in the trade. The basis of property received in a nontaxable or partly nontaxable trade is generally the same as the adjusted basis of the property given up.

2. Property Received From Spouse

If property is transferred to an individual from their spouse (or former spouse, if the transfer is incident to divorce), the person's basis is the same as their spouse's or former spouse's adjusted basis just before the transfer.

3. Recordkeeping

The transferor must give the transferee the records necessary to determine the adjusted basis and holding period of the property as of the date of the transfer.

4. Property Received as a Gift

To figure the basis in property received as a gift, the owner must know its adjusted basis to the donor just before it was given to them, its fair market value at the time it was given to them, the amount of any gift tax paid on it, and the date it was given to them.

If the fair market value of the property at the time of the gift was less than the donor's adjusted basis just before the gift, the owner's basis for gain on its sale or other disposition is the same as the donor's adjusted basis plus or minus any required adjustments to basis during the period they hold the property. Their basis for loss is its fair market value at the time of the gift plus or minus any required adjustments to basis during the period they hold the property.

If the individual uses the basis for figuring a gain and the result is a loss, and then uses the basis for figuring a loss and the result is a gain, they will have neither a gain nor a loss.

Example.

Rex receives a gift of investment property having an adjusted basis of \$10,000 at the time of the gift. The fair market value at the time of the gift is \$9,000. Rex later sells the property for \$9,500. He has neither gain nor loss. Rex's basis for figuring gain is \$10,000, and \$10,000 minus \$9,500 results in a \$500 loss. His basis for figuring loss is \$9,000, and \$9,500 minus \$9,000 results in a \$500 gain.

If the fair market value of the property at the time of the gift was equal to or more than the donor's adjusted basis just before the gift, the owner's basis for gain or loss on its sale or other disposition is the donor's adjusted basis plus or minus any required adjustments to basis during the period they hold the property. Also, the owner may be allowed to add to the donor's adjusted basis all or part of any gift tax paid, depending on the date of the gift. If the property was received as a gift before 1977, the basis in the property is the donor's adjusted basis increased by the total gift tax paid on the gift. However, the owner's basis cannot be more than the fair market value of the gift at the time it was gifted.

If an individual received property as a gift after 1976, their basis is the donor's adjusted basis increased by the part of the gift tax paid that was for the net increase in value of the gift. The owner can figure this part by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) is the net increase in value of the gift and the denominator (bottom part) is the amount of the gift.

The net increase in value of the gift is the fair market value of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift.

If an individual receives property in a transfer that is partly a sale and partly a gift, their basis is the larger of the amount they paid for the property or the transferor's adjusted basis in the property at the time of the transfer. Add to that amount the amount of any gift tax paid on the gift. For figuring loss, their basis is limited to the property's fair market value at the time of the transfer.

5. Property Received as Inheritance

If an individual inherited property, their basis in that property generally is its fair market value (its appraised value on the federal estate tax return) on: (1) the date of the decedent's death, or (2) the later alternate valuation date if the estate qualifies for, and elects to use, alternate valuation. If no federal estate tax return was filed, use the appraised value on the date of death for state inheritance or transmission taxes.

C. ADJUSTED BASIS

Before an individual can figure any gain or loss on a sale, exchange, or other disposition of property or figure allowable depreciation, depletion, or amortization, they usually must make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

1. Stocks and Bonds

The basis of stocks or bonds generally is the purchase price plus the costs of purchase, such as commissions and recording or transfer fees. If the owner acquired stocks or bonds other than by purchase, their basis is usually determined by the fair market value or the previous owner's adjusted basis.

The basis of stock must be adjusted for certain events that occur after purchase. For example, if a person receives more stock from nontaxable stock dividends or stock splits, they must reduce the basis of their original stock. They must also reduce their basis when they receive nontaxable distributions, because these are a return of capital.

If an investor can adequately identify the shares of stock or the bonds they sold, their basis is the cost or other basis of the particular shares of stock or bonds. If an investor buys and sells securities at various times in varying quantities and cannot adequately identify the shares sold, the basis of the securities sold is the basis of the securities acquired first. Except for certain mutual fund shares, the investor cannot use the average price per share to figure gain or loss on the sale of the shares.

Example.

Steve bought 100 shares of stock of XYZ Corporation in 1989 for \$10 a share. In January 1990 he bought another 200 shares for \$11 a share. In July 1990 he gave his son 50 shares. In December 1992 Steve bought 100 shares for \$9 a share. In April 2006 he sold 130 shares. Steve cannot identify the shares he disposed of, so he must use the stock he acquired first to figure the basis. The shares of stock he gave his son had a basis of \$500 ($50 \times \10). Steve figures the basis of the 130 shares of stock he sold in 2008 as follows:

<i>50 shares ($50 \times \\$10$) balance of stock bought in 1989</i>	<i>\$500</i>
<i>80 shares ($80 \times \\$11$) stock bought in January 1990</i>	<i>\$880</i>
<i>Total basis of stock sold in 2008</i>	<i>\$1,380</i>

An investor will make an adequate identification if they show that certificates representing shares of stock from a lot that they bought on a certain date or for a certain price were delivered to their broker or other agent. If the investor has left the stock certificates with their broker or other agent, they will make an adequate identification if they:

- ☐ Tell their broker or other agent the particular stock to be sold or transferred at the time of the sale or transfer, and

- ❑ Receive a written confirmation of this from their broker or other agent within a reasonable time;

If an investor bought stock in different lots at different times and holds a single stock certificate for this stock, they will make an adequate identification if they:

- ❑ Tell their broker or other agent the particular stock to be sold or transferred when they deliver the certificate to their broker or other agent; and
- ❑ Receive a written confirmation of this from their broker or other agent within a reasonable time.

Stock identified this way is the stock sold or transferred even if stock certificates from a different lot are delivered to the broker or other agent. If an investor sells part of the stock represented by a single certificate directly to the buyer instead of through a broker, they will make an adequate identification if they keep a written record of the particular stock that they intend to sell. These methods of identification of stocks also apply to bonds sold or transferred.

2. Shares in a Mutual Fund or REIT

The basis of shares in a regulated investment company (mutual fund) or a real estate investment trust (REIT) is generally figured in the same way as the basis of other stock.

3. Mutual Fund Load Charges

An investor's cost basis in a mutual fund often includes a sales fee, also known as a load charge. But, in certain cases, investors cannot include the entire amount of a load charge in their basis if the charge gives them a reinvestment right.

4. Average Basis for Mutual Fund Shares

Investors can choose to use the average basis of mutual fund shares if they acquired the shares at various times and prices and left them on deposit in an account kept by a custodian or agent.

5. Undistributed Capital Gains

If an investor had to include in their income any undistributed capital gains of the mutual fund or REIT, they can increase their basis in the stock by the difference between the amount they included and the amount of tax paid for them by the fund or REIT.

6. Automatic Investment Service

If an investor participates in an automatic investment service, their basis for each share of stock, including fractional shares, bought by the bank or other agent is the purchase price plus a share of the broker's commission.

7. Dividend Reinvestment Plans

If an investor participates in a dividend reinvestment plan and receives stock from the corporation at a discount, their basis is the full fair market value of the stock on the dividend payment date. The investor must include the amount of the discount in their income.

8. Stock Dividends

Stock dividends are distributions made by a corporation to the owners of its stock. Generally, stock dividends are not taxable to shareholders. If the stock dividends are not taxable, investors must divide their basis for the old stock between the old and new stock. If the new stock the investor received as a nontaxable dividend is identical to the old stock on which the dividend was declared, the investor should divide the adjusted basis of the old stock by the number of shares of old and new stock. The result is their basis for each share of stock.

Example 1.

Kim owned one share of common stock that she bought for \$45. The corporation distributed two new shares of common stock for each share held. Kim then had three shares of common stock. Her basis in each share is \$15 ($\$45 \div 3$).

Example 2.

Kim owned two shares of common stock. She had bought one for \$30 and the other for \$45. The corporation distributed two new shares of common stock for each share held. Kim had six shares after the distribution – three with a basis of \$10 each ($\$30 \div 3$) and three with a basis of \$15 each ($\$45 \div 3$).

If the new stock the investor received as a nontaxable dividend is not identical to the old stock on which it was declared, the basis of the new stock is calculated differently. In this case, the investor should divide the adjusted basis of the old stock between the old and the new stock in the ratio of the fair market value of each lot of stock to the total fair market value of both lots on the date of distribution of the new stock.

Example.

Richard bought a share of common stock for \$100. Later, the corporation distributed a share of preferred stock for each share of common stock held. At the date of distribution, Richard's common stock had a fair market value of \$150 and the preferred stock had a fair market value of \$50. Richard can figure the basis of the old and new stock by dividing his \$100 basis between them. The basis of his common stock is \$75 ($\$150/\$200 \times \100), and the basis of the new preferred stock is \$25 ($\$50/\$200 \times \100).

II. Wash Sales

Individuals cannot deduct losses from sales or trades of stock or securities in a wash sale. A wash sale occurs when someone sells or trades stock or securities at a loss and within 30 days before or after the sale the individual:

- ❑ Buys substantially identical stock or securities;
- ❑ Acquires substantially identical stock or securities in a fully taxable trade; or
- ❑ Acquires a contract or option to buy substantially identical stock or securities.

If an individual sells stock and their spouse or a corporation they control buys substantially identical stock, the individual also has a wash sale. If the loss was disallowed because of the wash sale rules, the individual must add the disallowed loss to the cost of the new stock or securities. The result is the individual's basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities. The holding period for the new stock or securities begins on the same day as the holding period of the stock or securities sold.

Example 1.

Nick buys 100 shares of X stock for \$1,000. Nick sells these shares for \$750 and within 30 days from the sale he buys 100 shares of the same stock for \$800. Because he bought substantially identical stock, he cannot deduct his loss of \$250 on the sale. However, Nick will add the disallowed loss of \$250 to the cost of the new stock, \$800, to obtain his basis in the new stock, which is \$1,050.

Example 2.

Nancy is an employee of a corporation that has an incentive pay plan. Under this plan, Nancy is given 10 shares of the corporation's stock as a bonus award. She includes the fair market value of the stock in her gross income as additional pay. Nancy later sells these shares at a loss. If she receives another bonus award of substantially identical stock within 30 days of the sale, she cannot deduct her loss on the sale.

A. OPTIONS AND FUTURES CONTRACTS

The wash sale rules apply to losses from sales or trades of contracts and options to acquire or sell stock or securities. They do not apply to losses from sales or trades of commodity futures contracts and foreign currencies. Losses from the sale, exchange, or termination of a securities future contract to sell generally are treated in the same manner as losses from the closing of a short sale.

B. WARRANTS

The wash sale rules apply if someone sells common stock at a loss and, at the same time, buys warrants for common stock of the same corporation. But if the individual sells warrants at a loss and, at the same time, buys common stock in the same corporation, the wash sale rules apply only if the warrants and stock are considered substantially identical, as discussed next.

C. SUBSTANTIALLY IDENTICAL

In determining whether stock or securities are substantially identical, one must consider all the facts and circumstances in each particular case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. However, they may be substantially identical in some cases. For example, in a reorganization, the stocks and securities of the predecessor and successor corporations may be substantially identical.

Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, where the bonds or preferred stock are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may make these bonds or preferred stock and the common stock substantially identical.

For example, preferred stock is substantially identical to the common stock if the preferred stock:

- ☐ Is convertible into common stock;
- ☐ Has the same voting rights as the common stock;
- ☐ Is subject to the same dividend restrictions;
- ☐ Trades at prices that do not vary significantly from the conversion ratio; and
- ☐ Is unrestricted as to convertibility.

D. MORE OR LESS STOCK BOUGHT THAN SOLD

If the number of shares of substantially identical stock or securities an individual buys within 30 days before or after the sale is either more or less than the number of shares sold, they must determine the particular shares to which the wash sale rules apply. This is done by matching the shares bought with an equal number of the shares sold. The shares or securities so matched are subject to the wash sale rules.

Example 1.

David bought 100 shares of M stock on September 24, 2007, for \$5,000. On December 21, 2007, he bought 50 shares of substantially identical stock for \$2,750. On December 28, 2007, David bought 25 shares of substantially identical stock for \$1,125. On January 4, 2008, he sold for

\$4,000 the 100 shares he bought in September. David has a \$1,000 loss on the sale. However, because he bought 75 shares of substantially identical stock within 30 days of the sale, he cannot deduct the loss (\$750) on 75 shares. He can deduct the loss (\$250) on the other 25 shares. The basis of the 50 shares bought on December 21, 2007, is increased by two-thirds ($50 \div 75$) of the \$750 disallowed loss. The new basis of those shares is \$3,250 ($\$2,750 + \500). The basis of the 25 shares bought on December 28, 2007, is increased by the rest of the loss to \$1,375 ($\$1,125 + \250).

Example 2.

David bought 100 shares of M stock on September 24, 2007. On February 1, 2008, he sold those shares at a \$1,000 loss. On each of the 4 days from February 12-15, 2008, David bought 50 shares of substantially identical stock. He cannot deduct his \$1,000 loss. David must add half the disallowed loss (\$500) to the basis of the 50 shares bought on February 12. Add the other half (\$500) to the basis of the shares bought on February 13.

E. GAIN AND LOSS ON SAME DAY

Losses from a wash sale of one block of stock or securities cannot be used to reduce any gains on identical blocks sold the same day.

F. DEALERS

The wash sale rules do not apply to a dealer in stock or securities if the loss is from a transaction made in the ordinary course of business.

G. SHORT SALES

The wash sale rules apply to a loss realized on a short sale if an individual sells, or enters into another short sale of, substantially identical stock or securities within a period beginning 30 days before the date the short sale is complete and ending 30 days after that date.

For purposes of the wash sale rules, a short sale is considered complete on the date the short sale is entered into, if:

- ☐ On that date, the investor owns stock or securities identical to those sold short (or by that date they enter into a contract or option to acquire that stock or those securities); and
- ☐ The investor later delivers the stock or securities to close the short sale.

Otherwise, a short sale is not considered complete until the property is delivered to close the sale. This treatment also applies to losses from the sale, exchange, or termination of a securities futures contract to sell.

Example.

On June 2, Lucy buys 100 shares of stock for \$1,000. She sells short 100 shares of the stock for \$750 on October 6. On October 7, Lucy buys 100 shares of the same stock for \$750. She closes the short sale on November 17 by delivering the shares bought on June 2. Lucy cannot deduct the \$250 loss (\$1,000 - \$750) because the date of entering into the short sale (October 6) is considered the date the sale is complete for wash sale purposes and Lucy bought substantially identical stock within 30 days from that date.

CHAPTER 4 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The basis of property an investor buys is usually its cost.
 - a) true
 - b) false
2. What is the basis of property transferred from one spouse to another:
 - a) its fair market value at the time it was acquired by the transferor spouse
 - b) the fair market value at the time of the transfer
 - c) the adjusted basis of the spouse at the time of the transfer
 - d) the higher of a and c above
3. Which of the following determine the basis of stocks or bonds:
 - a) the purchase price of the stocks or bonds alone
 - b) the purchase price of the stocks or bonds in addition to any costs associated with the purchase
 - c) the fair market value at the time of purchase
 - d) the lesser of a and c above
4. How does the “wash rule” affect tax issues related to the sale of stocks:
 - a) it prohibits taxpayers from taking losses from the sale of stocks they sold and substantially repurchased within 30 days
 - b) it limits profits of people who seek financial gain with “unclean” hands
 - c) it limits insiders from selling shares short when they know a company is going to announce bad news
 - d) it prohibits shareholders from selling stock unless they have owned it for at least 30 days

CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** Basis is a way of measuring an individual's investment in property for tax purposes. The cost is the amount paid in cash, debt obligations, or other property or services.

B: False is incorrect. There are times when an individual must use a basis other than cost. In these cases, they may need to know the property's fair value or the adjusted basis of the previous owner.

(See page 4-1 of the course material.)

2. A: Incorrect. The original basis is not used when it is transferred from one spouse to another.

B: Incorrect. The adjusted basis of the transferor spouse becomes the basis for the receiving spouse, not the fair market value.

C: Correct. The receiving person's basis is the same as the adjusted basis of the transferring spouse, whether or not the transfer is incident to divorce.

D: Incorrect. There is no such choice.

(See pages 4-2 to 4-3 of the course material.)

3. A: Incorrect. The purchase price is only part of the equation used to determine the basis of stocks or bonds.

B: Correct. The purchase price is added to acquisition costs, such as brokerage fees and commissions, in order to determine the basis.

C: Incorrect. The actual purchase price is what is relevant, not the fair market value to the extent there is a difference.

D: Incorrect. Only the actual purchase price is relevant in making this determination.

(See page 4-4 of the course material.)

4. **A: Correct.** The wash sale rule keeps taxpayers from selling a stock at a loss and substantially repurchasing the stock within 30 days and taking a tax loss on the transaction.

B: Incorrect. This rule has nothing to do with corporate greed or criminal action.

C: Incorrect. The rule is not aimed at insiders.

D: Incorrect. The rule does not prohibit such sales. However, it limits the ability of taxpayers to deduct losses from such transactions.

(See page 4-7 of the course material.)

Chapter 5: Sale of a Home

I. Introduction and Overview

For most Americans, the largest investment anyone will ever have is their home. It is therefore essential that accountants be able to advise their clients on the various tax implications of selling a home. This chapter explains the tax rules that apply when an individual sells their main home.

A. MAIN HOME

This section explains the term “main home.” Usually, the home an individual lives in most of the time is their main home and can be a:

- ❑ House;
- ❑ Houseboat;
- ❑ Mobile home;
- ❑ Cooperative apartment; or
- ❑ Condominium.

To exclude gain, an individual generally must have owned and lived in the property as their main home for at least two years during the five-year period ending on the date of sale.

1. Sale of Land Only

If an individual sells the land on which their main home is located, but not the house itself, they cannot exclude any gain they have from the sale of the land.

Example.

On March 4, 2008, Bill sells the land on which his main home is located. Bill buys another piece of land and moves his house to it. This sale is not considered a sale of his main home, and Bill cannot exclude any gain on the sale of the land.

2. More Than One Home

If an individual has more than one home, they can exclude gain only from the sale of their main home. A taxpayer must include in income the gain from the sale of any other home. If an individual has two homes and lives in both of them, their main home is ordinarily the one they live in most of the time.

Example 1.

Lisa owns and lives in a house in the city. She also owns a beach house, which she uses during summer months. The house in the city is Lisa's main home.

Example 2.

Connie owns a house, but she lives in another house that she rents. The rented house is Connie's main home.

3. Property Used Partly as Main Home

If an individual uses only part of the property as their main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property.

B. FIGURING GAIN OR LOSS

To figure the gain or loss on the sale of an individual's main home, the owner must know the selling price, the amount realized, and the adjusted basis. Subtract the adjusted basis from the amount realized to get the individual's gain or loss.

1. Selling Price

The selling price is the total amount an individual receives for their home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services the seller receives.

In some cases, an individual may have to sell their home because of a job transfer. If an employer pays an employee for a loss on the sale or for their selling expenses, the seller should not include the payment as part of the selling price. Rather, the employer will include the amount paid as wages and it will become part of the individual's gross income.

2. Option to Buy

If a buyer pays for an option to buy and later exercises the option, the amount received by the seller for the option must be added to the selling price of the home. If the option is not exercised, the seller must report the payment as ordinary income in the year the option expired.

3. Amount Realized

The amount realized is the selling price of the home minus selling expenses. Selling expenses include all of the following:

- ☐ Commissions;
- ☐ Advertising fees;

- ❑ Legal fees; and
- ❑ Loan charges paid by the seller, such as loan placement fees or “points.”

4. Adjusted Basis

While the seller owned their home, they may have made adjustments to their basis. If so, this adjusted basis must be determined before the seller can figure gain or loss on the sale of the home.

5. Amount of Gain or Loss

To figure the amount of gain or loss, the amount realized is compared to the adjusted basis. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part the seller can exclude, generally is taxable. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of an individual's main home cannot be deducted.

6. Jointly Owned Home

If an individual and their spouse sell their jointly owned home and file a joint return, they will calculate their gain or loss as one taxpayer.

7. Separate Returns

If a seller files a separate return from their spouse, each spouse must calculate their own gain or loss according to their ownership interest in the home. Each spouse's ownership interest is determined by state law.

8. Joint Owners Not Married

If two owners who are not married sell their jointly owned home, each must calculate their own gain or loss according to their ownership interest in the home.

II. Other Dispositions

The following rules apply to foreclosures and repossessions, abandonments, trades, and transfers to a spouse.

A. FORECLOSURE AND REPOSSESSION

If an individual's home was foreclosed on or repossessed, the owner is treated as having a sale. The owner will figure his or her gain or loss in generally the same way as a normal sale. However, the amount of the gain or loss depends, in part, on whether the owner was personally liable for repaying the debt secured by the home. An individual also may realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

1. Nonrecourse Debt

If an individual is not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount they realize includes the full debt canceled by the transfer. The full canceled debt is included even if the fair market value of the property is less than the canceled debt.

Example 1.

Chris bought a new car for \$15,000. He paid \$2,000 down and borrowed the remaining \$13,000 from the dealer's credit company. Chris is not personally liable for the loan (nonrecourse), but pledges the new car as security. The credit company repossessed the car because he stopped making loan payments. The balance due after taking into account the payments Chris made was \$10,000. The fair market value of the car when repossessed was \$9,000. The amount Chris realized on the repossession is \$10,000. That is the debt canceled by the repossession, even though the car's fair market value is less than \$10,000. Chris figures his gain or loss on the repossession by comparing the amount realized (\$10,000) with his adjusted basis (\$15,000). He has a \$5,000 nondeductible loss.

Example 2.

Abena paid \$200,000 for her home. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Abena is not personally liable for the loan (nonrecourse debt), but pledges the house as security. The bank foreclosed on the loan because Abena stopped making payments. When the bank foreclosed on the loan, the balance due was \$180,000, the fair market value of the house was \$170,000, and Abena's adjusted basis was \$175,000 due to a casualty loss she had deducted. The amount Abena realized on the foreclosure is \$180,000, the debt canceled by the foreclosure. She figures her gain or loss by comparing the amount realized (\$180,000) with her adjusted basis (\$175,000). She has a \$5,000 realized gain.

2. Recourse Debt

If an individual is personally liable for the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the canceled debt that is the individual's income from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. The owner is treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value.

Example 1.

Assume the same facts as in the previous Example 1, except Chris is personally liable for the car loan (recourse debt). In this case, the amount he realizes is \$9,000. This is the canceled debt (\$10,000) up to the car's fair market value (\$9,000). Chris figures his gain or loss on the repossession by comparing the amount realized (\$9,000) with his adjusted basis (\$15,000). He has a \$6,000 nondeductible loss. He also is treated as receiving ordinary income from cancellation of debt. That income is \$1,000 (\$10,000 - \$9,000). This is the part of the canceled debt not included in the amount realized.

Example 2.

Assume the same facts as in the previous Example 2, except Abena is personally liable for the loan (recourse debt). In this case, the amount she realizes is \$170,000. This is the canceled debt (\$180,000) up to the fair market value of the house (\$170,000). Abena figures her gain or loss on the foreclosure by comparing the amount realized (\$170,000) with her adjusted basis (\$175,000). She has a \$5,000 nondeductible loss. She also is treated as receiving ordinary income from cancellation of debt. That income is \$10,000 (\$180,000 - \$170,000). This is the part of the canceled debt not included in the amount realized.

3. Seller's (Lender's) Gain or Loss on Repossession

If an individual or entity finances a buyer's purchase of property and later acquires an interest in it through foreclosure or repossession, they may have a gain or loss on the acquisition.

4. Cancellation of Debt

If property that is repossessed or foreclosed on secures a debt for which the owner is personally liable (recourse debt), they generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession.

B. ABANDONMENT

If an individual abandons their home, they may have ordinary income. If the abandoned home secures a debt for which the owner is personally liable and the debt is canceled, the owner has ordinary income equal to the amount of the canceled debt.

C. TRADING HOMES

If an individual trades their old home for another home, they should treat the trade as a sale and a purchase.

Example.

Ray owned and lived in a home that had an adjusted basis of \$41,000. A real estate dealer accepted his old home as a trade-in and allowed him \$50,000 toward a new home priced at \$80,000. This is treated as a sale of his old home for \$50,000 with a gain of \$9,000 (\$50,000 – \$41,000). If the dealer had allowed Ray \$27,000 and assumed his unpaid mortgage of \$23,000 on his old home, Ray's sales price would still be \$50,000 (the \$27,000 trade-in allowed plus the \$23,000 mortgage assumed).

D. TRANSFER TO A SPOUSE

If an owner transfers their home to a spouse, or to a former spouse incident to a divorce, there is generally no gain or loss. This is true even if the individual receives cash or other consideration for the home. Therefore, the rules in this chapter do not apply.

Example.

Linda and George purchased a home while they were married and lived there together for several years. The couple divorced. As part of the settlement, Linda received the home. Linda paid George for the value of his half of the property and retained sole title to the home. This transaction does not result in any gain to Linda based on the valuation of the house.

III. Determining Basis

To calculate whether there has been a gain or a loss, a seller must know the basis of their home. In general, a seller's basis is determined by how they got the home. If a seller either bought or built their home, their basis is generally their actual cost. If the seller got the home in some other way, i.e. through inheritance or as a gift, their basis is generally the fair market value of the property at the time they received it, or, in the alternative, the adjusted basis of the person from whom they got the property.

While living in the home, the seller may have made adjustments to their basis. This is referred to as the adjusted basis of the home, and must also be calculated to determine gain or loss.

A. COST AS A BASIS

The cost of property is the amount the owner pays for it in cash, debt, obligation, other property or services.

1. Purchase

If an individual buys their home, their basis is its cost. This includes the purchase price and certain settlement or closing costs. Generally, the purchase price includes the down payment and any debt, such as a first or second mortgage or notes the individual gave the seller in payment for the home. If an individual builds, or contracts to build, a new home, their purchase price can include costs of construction.

2. Settlement Fees

When the seller bought their home, they may have paid settlement fees or closing costs in addition to the contract price of the property. A seller can include in their basis some of the settlement fees and closing costs they paid for buying the home. The seller cannot include in their basis the fees and costs for getting a mortgage loan. A fee paid for buying the home is any fee the individual would have had to pay even if they had paid cash for the home.

B. ADJUSTED BASIS

Adjusted basis is an individual's basis increased or decreased by certain amounts.

1. Increases to Basis

These include any:

- ☐ Additions and other improvements that have a useful life of more than one year;
- ☐ Special assessments for local improvements; and
- ☐ Amounts the owner spent after a casualty to restore damaged property.

2. Decreases to Basis

These include any:

- ☐ Gain the owner postponed from the sale of a previous home before May 7, 1997;
- ☐ Deductible casualty losses;
- ☐ Insurance payments the owner received or expect to receive for casualty losses;
- ☐ Payments the owner received for granting an easement or right-of-way;
- ☐ Depreciation allowed or allowable if the owner used their home for business or rental purposes;
- ☐ Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that the owner added to the basis of their home;
- ☐ Adoption credit the owner claimed for improvements added to the basis of their home;
- ☐ Nontaxable payments from an adoption assistance program of the owner's employer that they used for improvements added to the basis of the home;
- ☐ First-time homebuyer credit (allowed to certain first-time buyers of a home in the District of Columbia); and

- ❑ Energy conservation subsidy excluded from the owner's gross income because they received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

3. Improvements

These add to the value of a home, prolong its useful life, or adapt it to new uses. An owner adds the cost of additions and other improvements to the basis of their property. Examples include putting a recreation room or another bathroom in an unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving an unpaved driveway are improvements. An addition to a house, such as a new deck, a sunroom, or a garage, is also an improvement.

4. Repairs

These maintain a home in good condition but do not add to its value or prolong its life. Owners do not add their cost to the basis of their property. Examples include repainting a house inside or outside, fixing gutters or floors, repairing leaks or plastering, and replacing broken windows.

5. Importance of Recordkeeping

Homeowners should keep records to prove their home's adjusted basis. Ordinarily, an owner must keep records for three years after the due date for filing their return for the tax year in which they sold their home. But, if the owner sold a home before May 7, 1997, and postponed tax on any gain, the basis of that home affects the basis of the new home they bought. Owners should keep records proving the basis of both homes as long as they are needed for tax purposes. The records individuals should keep include:

- ❑ Proof of the home's purchase price and purchase expenses;
- ❑ Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis;
- ❑ Any worksheets that the owner used to figure the adjusted basis of the home they sold, the gain or loss on the sale, the exclusion, and the taxable gain;
- ❑ Any Form 2119, *Sale of Your Home*, that the owner filed to postpone gain from the sale of a previous home before May 7, 1997; and
- ❑ Any worksheets the owner used to prepare Form 2119, such as the *Adjusted Basis of Home Sold Worksheet* or the *Capital Improvements Worksheet* from the Form 2119 instructions.

IV. Excluding the Gain

Taxpayers may qualify to exclude from their income all or part of any gain from the sale of their main home. This means that, if they qualify, they will not have to pay tax on the gain up to the limit described later. To qualify, the taxpayer must meet the ownership and use tests described later. A taxpayer can choose not to take the exclusion. In that case, they must include the gain from the sale in their gross income on their tax return for the year of the sale.

A. MAXIMUM EXCLUSION

1. \$250,000 Exclusion

Individuals can exclude up to \$250,000 of the gain on the sale of their main home if all of the following are true:

- ☐ They meet the ownership test;
- ☐ They meet the use test; and
- ☐ During the two-year period ending on the date of the sale, they did not exclude gain from the sale of another home.

2. \$500,000 Exclusion

Taxpayers can exclude the entire gain on the sale of their main home up to \$500,000 if all of the following are true:

- ☐ They are married and file a joint return for the year;
- ☐ Either the owner or their spouse meets the ownership test;
- ☐ Both the owner and their spouse meet the use test; and
- ☐ During the two-year period ending on the date of the sale, neither the owner nor their spouse excluded gain from the sale of another home.

B. OWNERSHIP AND USE TESTS

To claim the exclusion, an individual must meet the ownership and use tests. This means that during the five-year period ending on the date of the sale, the individual must have owned the home for at least two years (the ownership test), and lived in the home as their main home for at least two years (the use test).

1. Exception

If an individual owned and lived in the property as their main home for less than two years, they can still claim an exclusion in some cases. The maximum amount they can claim will be reduced.

Example 1. Home owned and occupied for 3 years.

Amanda bought and moved into her main home in September 2005. She sold the home at a gain on September 15, 2008. During the 5-year period ending on the date of sale (September 16, 2003 – September 15, 2008), she owned and lived in the home for 3 years. She meets the ownership and use tests.

Example 2. Met ownership test but not use test.

Dan bought a home in 2002. After living in it for 6 months, he moved out. He never lived in the home again and sold it at a gain on June 28, 2008. He owned the home during the entire 5-year period ending on the date of sale (June 29, 2003 – June 28, 2008). However, he did not live in it for the required two years. He meets the ownership test but not the use test. He cannot exclude any part of his gain on the sale, unless he qualified for a reduced maximum exclusion.

2. Period of Ownership and Use

The required two years of ownership and use during the five-year period ending on the date of the sale do not have to be continuous. An individual can meet the tests if they can show that they owned and lived in the property as their main home for either 24 full months or 730 days (365×2) during the five-year period ending on the date of sale.

3. Temporary Absence

Short temporary absences for vacations or other seasonal absences, even if the owner rents out the property during the absences, are counted as periods of use.

Example.

Professor Paul Beard, who is single, bought and moved into a house on August 28, 2005. He lived in it as his main home continuously until January 5, 2007, when he went abroad for a 1-year sabbatical leave. During part of the period of leave, the house was unoccupied, and during the rest of the period, he rented it. On January 6, 2008, he sold the house at a gain. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, unless he qualifies for a reduced maximum exclusion (explained later). Even if he does qualify for a reduced maximum exclusion, he cannot exclude the part of the gain equal to the depreciation he claimed or should have claimed while renting the house.

4. Ownership and Use Tests Met at Different Times

Individuals can meet the ownership and use tests during different two-year periods. However, the owner must meet both tests during the five-year period ending on the date of the sale.

Example.

In 1997, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2005. In 2006, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 10, 2008, while still living in her daughter's home, she sold her apartment. Helen can exclude gain on the sale of her apartment because she met the ownership and use tests.

Her 5-year period is from July 11, 2003, to July 10, 2008, the date she sold the apartment. She owned her apartment from December 1, 2005, to July 10, 2008 (more than 2 years). She lived in the apartment from July 11, 2003 (the beginning of the 5-year period), to April 14, 2006 (more than 2 years).

5. Cooperative Apartment

If an individual sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, the individual:

- ❑ Owned the stock for at least 2 years; and
- ❑ Lived in the house or apartment that the stock entitles them to occupy as their main home for at least 2 years.

6. Exception for Individuals with a Disability

There is an exception to the use test if during the 5-year period before the sale of a home:

- ❑ The owner becomes physically or mentally unable to care for themselves; and
- ❑ They owned and lived in the home as their main home for a total of at least 1 year.

Under this exception, an individual is considered to live in their home during any time that they own the home and live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in their condition. If an individual meets this exception to the use test, they still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

7. Previous Home Destroyed or Condemned

For the ownership and use tests, an individual can add the time they owned and lived in a previous home that was destroyed or condemned to the time they owned and lived in the home on which they wish to exclude gain. This rule applies if any part of the basis of the home the individual sold depended on the basis of the destroyed or condemned home. Otherwise, the individual must have owned and lived in the same home for 2 of the 5 years before the sale to qualify for the exclusion.

8. Married Persons

If an individual and their spouse file a joint return for the year of sale, they can exclude gain if either spouse meets the ownership and use tests.

Example 1. One spouse sells a home.

Emily sells her home in June 2008. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to \$250,000 of gain on a separate or joint return for 2008.

Example 2. Each spouse sells a home.

The facts are the same as in Example 1 except that Jamie also sells a home in 2008. He meets the ownership and use tests on his home. Emily and Jamie can each exclude up to \$250,000 of gain.

If an individual's spouse died and they did not remarry before the date of sale, the individual is considered to have owned and lived in the property as their main home during any period of time when their spouse owned and lived in it as a main home.

a. Home Transferred From Spouse

If a home was transferred to an individual by their spouse (or former spouse if the transfer was incident to divorce), the individual is considered to have owned it during any period of time when their spouse owned it.

b. Use of Home After Divorce

An individual is considered to have used property as their main home during any period when they owned it and their spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as their main home.

C. REDUCED MAXIMUM EXCLUSION

An individual can claim an exclusion, but the maximum amount of gain that they can exclude will be reduced, if either of the following is true:

- ☐ They did not meet the ownership and use tests, but the primary reason they sold the home was a change in place of employment, health or unforeseen circumstances, discussed later; or
- ☐ Their exclusion would have been disallowed because of the rule described later, except that the primary reason they sold the home was a change in place of employment, health or unforeseen circumstances.

1. Unforeseen Circumstances

The sale of a main home is because of an unforeseen circumstance if the owner's primary reason for the sale is the occurrence of an event that they did not anticipate before buying and occupying their main home.

2. More Than One Home Sold During 2-Year Period

Individuals cannot exclude gain on the sale of their home if, during the 2-year period ending on the date of the sale, they sold another home at a gain and excluded all or part of that gain. Individuals can still claim an exclusion, but the maximum amount of gain they can exclude will be reduced, if the primary reason they sold their home was a change in place of employment, health or unforeseen circumstance.

3. Business Use or Rental of Home

Individuals may be able to exclude the gain from the sale of a home that they have used for business or to produce rental income, but the individuals must meet the ownership and use tests.

Example 1.

On May 30, 2002, Amy bought a house. She moved in on that date and lived in it until May 31, 2004, when she moved out of the house and put it up for rent. The house was rented from June 1, 2004, to March 31, 2006. Amy moved back into the house on April 1, 2006, and lived there until she sold it on January 31, 2008. During the 5-year period ending on the date of the sale (February 1, 2003 – January 31, 2008), Amy owned and lived in the house for more than 2 years as shown in the table below.

Five-Year Period	Used As Home	Used As Rental
2/1/03 – 5/31/04	16 months	
6/1/04 – 3/31/06		22 months
4/1/06 – 1/31/08	22 months	
	38 months	22 months

Amy can exclude gain up to \$250,000. But she cannot exclude the part of the gain equal to the depreciation she claimed, or should have claimed, for renting the house, as explained after Example 2.

Example 2.

William owned and used a house as his main home from 2002 through 2005. On January 1, 2006, he moved to another state. He rented his house from that date until April 30, 2008, when he sold it. During the 5-year period ending on the date of sale (May 1, 2003 – April 30, 2008), William owned and lived in the house for 32 months (more than 2 years). He can exclude gain up to \$250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed, or should have claimed, for renting the house.

D. SPECIAL SITUATIONS

The following situations may affect an individual's exclusion.

1. Expatriates

An individual cannot claim the exclusion if the expatriation tax applies to them. The expatriation tax applies to U.S. citizens who have renounced their citizenship (and long-term residents who have ended their residency) if one of their principal purposes was to avoid U.S. taxes.

2. Home Destroyed or Condemned

If an individual's home was destroyed or condemned, any gain (for example, because of insurance proceeds they received) qualifies for the exclusion. Any part of the gain that cannot be excluded (because it is more than the limit) may be postponed.

3. Sale of Remainder Interest

Individuals can generally choose to exclude gain from the sale of a remainder interest in their home. If an individual makes this choice, they cannot choose to exclude gain from the sale of any other interest in the home that they sell separately.

However, individuals cannot exclude gain from the sale of a remainder interest in their home to a related person. Related persons include brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

4. Recapturing a Federal Mortgage Subsidy

If an individual financed their home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), they may have to recapture (pay back) all or part of the benefit they received from that program when they sell or otherwise dispose of their home. An individual recaptures the benefit by increasing their federal income tax for the year of the sale. The recapture applies to loans that came from the proceeds of qualified mortgage bonds or were based on mortgage credit certificates. The recapture rule also applies to assumptions of these loans.

The recapture of the federal mortgage subsidy applies only if an individual meets both of the following conditions:

- ☐ They sell or otherwise dispose of their home at a gain and during the first 9 years after the date they closed their mortgage loan; and
- ☐ Their income for the year of disposition is more than that year's adjusted qualifying income for their family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

The recapture does not apply if the mortgage loan was a qualified home improvement loan of not more than \$15,000, the home is disposed of as a result of the owner's death, the individual disposes of the home more than 9 years after the date they closed their mortgage loan, they transfer the home to their spouse, or to their former spouse incident to a divorce, where no gain is included in their income, they dispose of a home at a loss, the home is destroyed by a casualty, and the owner repairs it or replaces it on its original site within 2 years after the end of the tax year when the destruction happened, or the owner refinances their mortgage loan.

CHAPTER 5 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following requirements must a taxpayer meet in order to be able to exclude the gain on the sale of a home:
 - a) the taxpayer must have lived in the property for at least 18 months immediately prior to the sale
 - b) the taxpayer must have lived in the home for at least two years immediately prior to the sale
 - c) the taxpayer must have lived in the home for two out of the five years immediately prior to the time of the sale
 - d) the taxpayer must not own any other real estate
2. How is a foreclosure of real estate treated for tax purposes:
 - a) the owner is given a tax loss equal to the fair market value of the real estate at the time of the foreclosure
 - b) in the case of a nonrecourse loan, the owner has a gain equal to the amount of the cancelled debt
 - c) whether or not the loan is a recourse loan, the individual has a gain equal to the amount of the debt still owed on the property
 - d) the owner is given a tax credit to help them secure a new home
3. The cost of additions and other improvements that have a useful life of more than one year should be included as adjustments to the basis of an individual's home.
 - a) true
 - b) false
4. For a taxpayer that qualifies, the maximum amount of income an individual may exclude from income taxes is:
 - a) \$250,000
 - b) \$500,000
 - c) \$750,000
 - d) \$1,000,000
5. An individual cannot claim an exclusion if they do not meet either the ownership or the use test, even if due to unforeseen circumstances.
 - a) true
 - b) false

CHAPTER 5 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The time required is two years, not 18 months.

B: Incorrect. The two years need to have been within five years of the sale.

C: Correct. In addition, the property must have served as the primary home of the taxpayer.

D: Incorrect. The home must have been the primary home of the taxpayer. However, that does not preclude them from owning other residential or commercial real estate in order to qualify for the exclusion.

(See page 5-1 of the course material.)

2. A: Incorrect. If anything, the taxpayer must be stuck with a gain. They are not given a loss under such circumstances.

B: Correct. This is because the debt is in essence forgiven. It does not matter whether or not the amount owed was more or less than the value of the home at the time of the repossession.

C: Incorrect. This is only the rule in the case of a nonrecourse loan.

D: Incorrect. There is no such tax credit.

(See pages 5-3 to 5-4 of the course material.)

3. **A: True is correct.** Examples of improvements that should be used to adjust basis include putting a recreation room or another bathroom in an unfinished basement, putting up a new fence, putting on a new roof, or paving an unpaved driveway.

B: False is incorrect. Repairs differ from improvements, and do not add value or prolong the life of the home. These costs should not be included in an adjustment to basis. Examples of repairs include repainting a house, fixing gutters, or replacing broken windows.

(See pages 5-7 to 5-8 of the course material.)

4. **A: Correct.** This is the maximum exclusion for individual taxpayers; the exclusion is higher for a married couple.

B: Incorrect. A couple filing a joint return can exclude up to \$500,000, but a single taxpayer is limited to \$250,000.

C: Incorrect. The limit for a single taxpayer or a married filing separately is only \$250,000.

D: Incorrect. The maximum exclusion for a single taxpayer is \$250,000.

(See page 5-9 of the course material.)

5. A: True is incorrect. If the primary reason the individual did not meet the ownership or use test was a change in place of employment, health, or other unforeseen circumstance, then the individual can still claim an exclusion of a reduced amount.

B: False is correct. Although the maximum amount of the exclusion would be reduced, an exclusion is still allowed if the reason the ownership or use test was not met was due to a change in employment, health, or other unforeseen circumstance.

(See page 5-12 of the course material.)

Chapter 6: Rental Income and Expenses

Many individuals buy second homes either for their own use and enjoyment or to rent and produce income as part of their financial plan. Even if an individual chooses to use a second home solely for their own use and not as a rental, there are important tax implications to understand. This chapter discusses rental income and expenses. It covers topics including rental income, rental expenses, personal use of a dwelling unit, including vacation homes, depreciation and limits on rental loss.

I. Rental Income and Expenses

A. RENTAL INCOME

Taxpayers must generally include in their gross income all amounts received as rent. Rental income is any payment the owner receives for the use or occupation of property. In addition to amounts received as normal rent payments, there are other amounts that may be rental income.

1. Time for Reporting

For cash basis taxpayers, rental income should be reported on the return for the year the owner actually or constructively received it. Income is constructively received when it is made available to the recipient, i.e. when it is credited to the owner's bank account.

2. Advance Rent

Advance rent is any amount received by the owner before the period that it covers. Owners should include advance rent in their rental income in the year it was received, regardless of the period covered or the method of accounting they use.

Example.

Steve signs a 10-year lease to rent his property. In the first year, he receives \$5,000 for the first year's rent and \$5,000 as rent for the last year of the lease. Steve must include \$10,000 in his income in the first year.

3. Security Deposits

Owners should not include a security deposit in their income when they receive it if they intend to return it to the tenant at the end of the lease. But if the owner keeps part or all of the security deposit during any year because the tenant does not live up to the terms of the lease, the amount the owner keeps should be included as income for that year. If an amount called a "security deposit" is to be used as a final payment of rent, it is advance rent and should be included as income when it is received.

4. Payment for Canceling a Lease

If a tenant pays an owner to cancel a lease, the amount received is rent. It should be included as income in the year received regardless of the owner's method of accounting.

5. Expenses Paid by Tenant

If a tenant pays any of the owner's expenses, the payments are rental income. They can be deducted to the extent they meet the requirements of deductible rental expense.

6. Property or Services

If an owner receives property or services instead of money as rent, the fair market value of the property or services received should be included as rental income. If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

7. Rental of Property Also Used as a Home

If an owner rents property that they also use as their home and they rent it fewer than 15 days during the tax year, they do not need to include the rent received as income and likewise may not deduct rental expenses.

B. RENTAL EXPENSES

This section discusses repairs and certain other expenses of renting property that an owner can ordinarily deduct from their rental income. Such expenses can normally be deducted in the year they are paid.

1. Vacant Rental Property

If an individual holds property for rental purposes, they may be able to deduct their ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, the individual cannot deduct any loss of rental income for the period the property is vacant.

2. Pre-Rental Expenses

Owners can deduct their ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time they make it available for rent.

3. Depreciation

Owners can begin to depreciate rental property when it is ready and available for rent.

4. Expenses for Rental Property Sold

If an individual sells property that they held for rental purposes, they can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

5. Personal Use of Rental Property

If an owner sometimes uses their rental property for personal purposes, they must divide their expenses between rental and personal use. Also, the rental expense deductions may be limited.

C. REPAIRS AND IMPROVEMENTS

Owners can deduct the cost of repairs to their rental property. On the other hand, the cost of improvements is not deductible. The cost of improvements is recovered through depreciation, discussed later. An individual who owns rental property must therefore separate the cost of repairs and improvements and keep accurate records showing which is which.

1. Repairs

A repair is something that keeps the property in good operating condition. It does not materially add to the value of the property or substantially prolong its life. Repainting property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs. If an owner makes repairs as part of an extensive remodeling or restoration of the property, the whole job is an improvement.

2. Improvements

An improvement adds to the value of the property, prolongs its useful life, or adapts it to new uses. Improvements include the following items:

- ☐ Putting a recreation room in an unfinished basement;
- ☐ Paneling a den;
- ☐ Adding a bathroom or bedroom;
- ☐ Putting decorative grillwork on a balcony;
- ☐ Putting up a fence;
- ☐ Putting in new plumbing or wiring;
- ☐ Putting in new cabinets;
- ☐ Putting on a new roof; or
- ☐ Paving a driveway.

The cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

3. Other Expenses

Other expenses an owner can deduct from rental income include advertising, cleaning and maintenance services, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation. For example, an owner can deduct the cost of traveling away from home if the primary purpose is to collect rental income or manage or maintain rental property.

D. PROPERTY CHANGED TO RENTAL USE

If an owner changes their home or other property, (or a part of it), to rental use at any time other than at the beginning of their tax year, they must divide yearly expenses, such as taxes and insurance, between rental use and personal use. The owner can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes. Property should be treated as having been placed in service on the conversion date for purposes of depreciation.

An owner cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, the owner can include the home mortgage interest and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

Example.

Robert's tax year is the calendar year. He moved from his home in May and started renting it on June 1. Robert can deduct as rental expenses seven-twelfths of his yearly expenses, such as taxes and insurance. Starting with June, he can deduct as rental expenses the amounts he pays for items generally billed monthly, such as utilities.

E. RENTING PART OF PROPERTY

If an owner rents part of their property, they must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though they actually had two separate pieces of property.

The owner can deduct the expenses related to the part of the property used for rental purposes, such as home mortgage interest and real estate taxes, as rental expenses on Schedule E (Form 1040). The owner can deduct the expenses for the part of the property used for personal purposes, subject to certain limitations, only if they itemize their deductions on Schedule A (Form 1040). They can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of the house. The owner cannot deduct any part of the cost of the first phone line even if their tenants have unlimited use of it.

An owner does not have to divide the expenses that belong only to the rental part of their property. For example, if an owner paints a room that they rent, or if they pay premiums for liability insurance in connection with renting a room in their home, the entire cost is a rental expense. If an owner installs a second phone line strictly for their tenants' use, all of the cost of the second line is deductible as a rental expense.

If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, the owner must divide the expense between the rental use and the personal use. The owner can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense are one based on the number of rooms in the home and one based on the square footage of the home.

II. Personal Use of a Dwelling (Vacation Homes)

If an individual has any personal use of a dwelling unit (including vacation home) that they rent, they must divide their expenses between rental use and personal use.

If the owner used their dwelling unit for personal purposes long enough during the tax year, it will be considered a dwelling unit used as a home. If so, the owner cannot deduct rental expenses that exceed rental income for that property. If the dwelling unit is not considered a dwelling unit used as a home, the owner can deduct rental expenses that exceed rental income for that property subject to certain limits.

If an owner uses the dwelling unit as a home and rents it fewer than 15 days during the year, they do not include any of the rent in their income and do not deduct any of the rental expenses.

A. DWELLING UNIT

A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example.

Linda rents a room in her home that is always available for short-term occupancy by paying customers. She does not use the room herself, and she allows only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

B. DWELLING UNIT USED AS A HOME

The tax treatment of rental income and expenses for a dwelling unit that the owner also uses for personal purposes depends on whether the owner uses it as a home. An owner is considered to use a dwelling unit as a home during the tax year if they use it for personal purposes more than the greater of:

- ❑ 14 days; or
- ❑ 10% of the total days it is rented to others at a fair rental price.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, the owner cannot count that day as a day of rental in determining if they have used it for 10 percent of the total days. Instead, they should count it as a day of personal use in applying both of the above. This rule does not apply when dividing expenses between rental and personal use.

A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property. The following examples show how to determine whether an owner used their rental property as a home.

Example 1.

Joe converted the basement of his home into an apartment with a bedroom, a bathroom, and a small kitchen. He rented the basement apartment at a fair rental price to college students during the regular school year. Joe rented to them on a 9-month lease (273 days). During June (30 days), Joe's brother stayed with him and lived in the basement apartment rent free. The basement apartment was used as a home because Joe used it for personal purposes for 30 days. Rent-free use by his brother is considered personal use. Joe's personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).

Example 2.

Carol rented the guest bedroom in her home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Her sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July. The room was used as a home because Carol used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the 27 days it was rented (3 days).

Example 3.

Rebecca owns a cottage in a resort area. She rented it at a fair rental price for a total of 170 days during the year. For 12 of those days, the tenant was not able to use the cottage and allowed Rebecca to use it even though she did not refund any of the rent. Her family actually used the cottage for 10 of those days. Therefore, the cottage is treated as having been rented for 160 (170 - 10) days. Rebecca's family also used the cottage for 7 other days during the year. Rebecca used the cottage as a home because she used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the 160 days it was rented (16 days).

C. USE AS A MAIN HOME BEFORE OR AFTER RENTING

For purposes of determining whether a dwelling unit was used as a home, owners do not count as days of personal use the days they used the property as their main home before or after renting it or offering it for rent in either of the following circumstances:

- ❑ They rented or tried to rent the property for 12 or more consecutive months; or
- ❑ They rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because they sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

D. FIGURING DAYS OF PERSONAL USE

A day of personal use of a dwelling unit is any day that it is used by any of the following persons:

- ❑ The owner or any other person who has an interest in it, unless the owner rents it to another owner as his or her main home under a shared equity financing agreement;
- ❑ A member of the owner's family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.);
- ❑ Anyone under an arrangement that lets the owner use some other dwelling unit; or
- ❑ Anyone at less than a fair rental price.

If the other person or member of the family has more than one home, his or her main home is ordinarily the one lived in most of the time.

Example 1.

Jan and her neighbor are co-owners of a condominium at the beach. Jan rents the unit to vacationers whenever possible. The unit is not used as a main home by anyone. Jan's neighbor uses the unit for two weeks every year. Because her neighbor has an interest in the unit, both of them are considered to have used the unit for personal purposes during those 2 weeks.

Example 2.

Rick and his neighbors are co-owners of a house under a shared equity financing agreement. Rick's neighbors live in the house and pay him a fair rental price. Even though the neighbors have an interest in the house, the days his neighbors live there are not counted as days of personal use by Rick. This is because his neighbors rent the house as their main home under a shared equity financing agreement.

Example 3.

Lisa owns a rental property that she rents to her son. Her son has no interest in this dwelling unit. He uses it as his main home. He pays a fair rental price for the property. The son's use of the property is not personal use by Lisa because her son is using it as his main home, he has no interest in the property, and he is paying a fair rental price.

E. DONATION OF USE OF PROPERTY

An owner uses a dwelling unit for personal purposes if:

- ❑ They donate the use of the unit to a charitable organization;
- ❑ The organization sells the use of the unit at a fundraising event; and
- ❑ The "purchaser" uses the unit.

III. Depreciation

Owners recover their cost in income producing property through yearly tax deductions. This is done by depreciating the property; that is, by deducting some of the cost on each year's tax return. Three basic factors determine how much depreciation an owner can deduct. They are:

- ❑ The owner's basis in the property;
- ❑ The recovery period for the property; and
- ❑ The depreciation method used.

An owner cannot simply deduct their mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense. The owner can deduct depreciation only on the part of their property used for rental purposes. Depreciation reduces the owner's basis for figuring gain or loss on a later sale or exchange.

Note also that an owner can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

A. CLAIMING THE CORRECT AMOUNT OF DEPRECIATION

Owners should claim the correct amount of depreciation each tax year. Even if an owner did not claim depreciation that they were entitled to deduct, they must still reduce their basis in the property by the full amount of depreciation that they could have deducted.

If an owner claimed less depreciation than allowable in an earlier year, they can change their accounting method to take a deduction in the current year for the unclaimed depreciation. To change an accounting method, a taxpayer must have the consent of the IRS. In some instances, automatic consent is available.

B. DEPRECIATION METHODS

There are three ways to figure depreciation. The depreciation method a taxpayer uses depends on the type of property and when the property was placed in service. For property used in rental activities, an owner will use one of the following:

- ☐ MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986;
- ☐ ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987; or
- ☐ Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

Also, remember that an owner's total of all their yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, an individual's yearly depreciation deductions include any depreciation that they were allowed to claim, even if it was not actually claimed.

C. MACRS

Most business and investment property placed in service after 1986 is depreciated using MACRS. MACRS consists of two systems that determine how an owner depreciates their property – the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). GDS is used to figure depreciation deduction for property used in most rental activities, unless the owner elects the ADS.

To figure their MACRS deduction, the owner needs to know the following information about their property:

- ☐ Its recovery period;
- ☐ Its placed-in-service date; and
- ☐ Its depreciable basis.

1. Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. Under GDS, the recovery period of an asset is generally the same as its property class. The property classes under GDS are:

- ❑ 3-year property;
- ❑ 5-year property;
- ❑ 7-year property;
- ❑ 10-year property;
- ❑ 15-year property;
- ❑ 20-year property;
- ❑ Nonresidential real property; and
- ❑ Residential rental property.

Recovery periods for property used in rental activities are shown in Table 6-1, below. The class to which property is assigned is determined by its class life.

2. Additions or Improvements to Property

Property owners should treat depreciable additions or improvements they make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

- ❑ The date the addition or improvement is placed in service; or
- ❑ The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the original property if it were placed in service at the same time as the addition or improvement.

Example.

Cal owns a residential rental house that he has been renting since 1986 and is depreciating under ACRS. Cal puts an addition onto the house and he placed it in service in 2008. He must use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property over 27.5 years.

3. Placed-in-Service Date

An owner can begin to depreciate property when they place it in service in their trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

4. Depreciable Basis

To deduct the proper amount of depreciation each year, an owner must first determine their basis in the property they intend to depreciate. The basis used for figuring depreciation is the owner's original basis in the property increased by any additions or improvements made to the property. The original basis is usually the property's cost. However, if an individual acquired the property in some other way, such as by inheriting it, getting it as a gift, or building it, they may have to figure their original basis in another way. Other adjustments could also affect basis.

5. Conventions

Under MACRS, conventions establish when the recovery period begins and ends. The convention an owner uses determines the number of months for which they can claim depreciation in the year they place property in service and in the year they dispose of the property.

a. Mid-month Convention

A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, an owner treats all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

b. Mid-quarter Convention

A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property the owner placed in service during the tax year.

c. Half-year Convention

The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, an owner treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year. If this convention applies, the owner deducts a half-year of depreciation for the first year and the last year that they depreciate the property. They deduct a full year of depreciation for any other year during the recovery period.

Table 6-1. MACRS Recovery Periods for Property Used in Rental Activities

Type of Property	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: Typewriters, Calculators, Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as: Stoves, Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as: Desks, Files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	40 years
Additions and improvements, such as a new roof	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

Example.

During the tax year, Jordan Gregory purchased the following items to use in his rental property.

- *A dishwasher for \$400 that he placed in service in January.*
- *Used furniture for \$100 that he placed in service in September.*
- *A refrigerator for \$500 that he placed in service in October.*

Jordan uses the calendar year as his tax year. He elects not to claim the special depreciation allowance, discussed earlier. The total basis of all property placed in service in that year is \$1,000. The \$500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds \$400 ($40\% \times \$1,000$). Jordan must use the mid-quarter convention instead of the half-year convention for all three items.

Table 6-2-A. MACRS 5-Year Property

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

Table 6-2-B. MACRS 7-Year Property

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

Table 6-2-C. MACRS 15-Year Property

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

Table 6-2-D. Residential Rental Property (27.5-year)

	Use the row for the month of the taxable year placed in service.					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
Mar.	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
Jun.	1.970	3.636	3.636	3.636	3.636	3.636
Jul.	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.4555	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

Example 1.

Bernie purchased a stove and refrigerator and placed them in service in June. His basis in the stove is \$600 and his basis in the refrigerator is \$1,000. After figuring the special depreciation allowance his basis in the stove is \$300 and his basis in the refrigerator is \$500. Both are 5-year property. Using the half-year convention column in Table 6-2-A, Bernie finds the depreciation percentage for year 1 is 20%. For that year, his depreciation deduction is \$60 ($\$300 \times .20$) for the stove and \$100 ($\$500 \times .20$) for the refrigerator. For year 2, Bernie finds his depreciation percentage is 32%. That year's depreciation deduction will be \$96 ($\$300 \times .32$) for the stove and \$160 ($\$500 \times .32$) for the refrigerator.

Example 2.

Assume the same facts as in Example 1, except Bernie buys the refrigerator in October instead of June. He must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis (\$1,000) is more than 40% of the total basis of all property placed in service during the year ($\$1,600 \times .40 = \640). Because Bernie placed the refrigerator in service in October, he uses the fourth quarter column of Table 6-2–A and finds that the depreciation percentage for year 1 is 5%. His depreciation deduction for the refrigerator (after figuring the special depreciation allowance) is \$25 ($\$500 \times .05$). Because he placed the stove in service in June, he uses the second quarter column of Table 6-2–A and finds that the depreciation percentage for year 1 is 25%. For that year, his depreciation deduction for the stove (after figuring the special depreciation allowance) is \$75 ($\$300 \times .25$).

D. OTHER RULES ABOUT DEPRECIABLE PROPERTY

In addition to the rules about what methods an owner can use, there are other rules individuals should be aware of with respect to depreciable property.

1. Gain From Disposition

If an individual disposes of depreciable property at a gain, they may have to report, as ordinary income, all or part of the gain.

2. Limits on Rental Losses

Rental real estate activities are generally considered passive activities, and the amount of loss an individual can deduct is limited. Generally, an individual cannot deduct losses from rental real estate activities unless they have income from other passive activities. However, an individual may be able to deduct rental losses without regard to whether they have income from other passive activities if they “materially” or “actively” participated in the rental activity. This topic is discussed in more detail in Chapter 3.

Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986. Likewise, this subject is discussed in more detail in Chapter 3.

CHAPTER 6 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. How does federal tax law treat security deposits received by landlords:
 - a) security deposits are never considered to be income to the landlord
 - b) security deposits are always considered to be income to the landlord when received
 - c) security deposits are not income at the time received if it is the landlord's intent to return them to the tenant at the time the tenant vacates the property
 - d) 50% of the security deposit is considered income
2. Property owners can deduct which of the following expenses incurred for their rental property:
 - a) repairs but not improvements
 - b) all repairs and improvements
 - c) improvements but not repairs
 - d) any expense in excess of \$500
3. Under which of the following circumstances is the owner of a dwelling deemed to have used it for personal use:
 - a) if they used it for at least 10 days within the year
 - b) if they used it for at least 14 days within the year
 - c) it is used personally for 10% or more of the total days that is rented to others at a fair rental price
 - d) either b or c above
4. An owner is automatically considered to have used their dwelling unit for personal use if they donate the use of the unit to a charitable organization.
 - a) true
 - b) false
5. Even if an owner does not claim depreciation that they were entitled to deduct, they must still reduce their basis in the property by the full amount of depreciation that they could have deducted.
 - a) true
 - b) false

6. Under the MACRS general depreciation system (GDS), the recovery period for appliances such as stoves and refrigerators used in rental activities is five years.
- a) true
 - b) false

CHAPTER 6 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Deposits are generally not considered income, but it depends on other factors including the intent of the landlord.

B: Incorrect. In some cases deposits are considered income, but there is no such categorical rule. Indeed, the presumption seems not to treat deposits as income.

C: Correct. To the extent the landlord intends to refund the deposit at the end of the leasehold, it is not income.

D: Incorrect. Deposits are either income or not; there is no such percentage.

(See page 6-1 of the course material.)

2. **A: Correct.** Any money spent on actual repairs to rental property is deductible as a business expense associated with that rental. A repair is something needed to keep up the property, i.e., patching a leaking roof or fixing a fallen fence.

B: Incorrect. Improvements, things which add value to the property, are generally not deductible as the owner is able to recoup such investments through depreciation.

C: Incorrect. Repairs, not improvements, are subject to a deduction while improvements must be depreciated.

D: Incorrect. There is no such minimum expenditure. The question is whether the item is a repair, which is deductible, or an improvement which must be depreciated.

(See page 6-3 of the course material.)

3. A: Incorrect. The owner must use it for 14 days for it to be considered as a personal use dwelling, in which case certain costs must be allocated for tax purposes.

B: Incorrect. An owner who uses a dwelling for at least 14 days will be considered to have had some personal use for tax purposes. However, this is not the most correct answer.

C: Incorrect. Under this circumstance, the dwelling will be considered to have had personal use for tax purposes. However, this is not the correct answer.

D: Correct. Under either scenario, a taxpayer will be deemed to have used the property for personal use. If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, the owner cannot count that day as a day of rental in determining if they have used it for 10 percent of the total days. Instead, they should count it as a day of personal use in applying both of the above. This rule does not apply when dividing expenses between rental and personal use.

(See pages 6-5 to 6-6 of the course material.)

4. A: True is incorrect. It would be considered as used for personal use if not only was it donated to the charitable organization, but if it also was sold by the organization at a fundraising event, and then used by the “purchaser.”

B: False is correct. The donation of the unit alone would not be enough for it to be included as personal use for the year.

(See page 6-8 of the course material.)

5. **A: True is correct.** Owners should claim the correct amount of depreciation each year.

B: False is incorrect. If an owner claimed less depreciation than allowable in an earlier year, they can change their accounting method to take a deduction in the current year for the unclaimed depreciation. To make this change, the taxpayer must have the consent of the IRS.

(See page 6-9 of the course material.)

6. **A: True is correct.** Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. Appliances such as stoves and refrigerators have a recovery period of 5 years under the GDS.

B: False is incorrect. If the owner elected to apply the alternative depreciation system (ADS), the recovery period for these appliances would be 9 years.

(See page 6-12 of the course material.)

Chapter 7: Mutual Fund Distributions

For most Americans, the most common type of equity investment is the mutual fund. Whether it is through a 401(K), a pension plan or a direct investment outside the scope of a retirement plan, mutual funds remain a very popular form of investment. Given the widespread popularity of mutual funds, this chapter provides a look at these investment vehicles and the rules that govern the taxation of their distributions. As with other investment vehicles, income tax treatment is a key factor in determining whether it is an appropriate investment.

I. An Overview of Mutual Funds

Over the past decade, American investors increasingly have turned to mutual funds to save for retirement and other financial goals. Mutual funds can offer the advantages of diversification and professional management. But, as with other investment choices, investing in mutual funds involves risk. Also, fees and taxes will diminish a fund's returns.

A. WHAT ARE THEY

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the mutual fund owns are known as its portfolio. Each share represents an investor's proportionate ownership of the fund's holdings and the income those holdings generate.

B. OTHER TYPES OF INVESTMENT COMPANIES

Legally known as an "open-end company," a mutual fund is one of three basic types of investment companies. The two other basic types of investment companies are described below.

1. Closed-End Funds

Unlike mutual funds, this fund sells a fixed number of shares at one time (in an initial public offering) that later trade on a secondary market.

2. Unit Investment Trusts (UITs)

These make a one-time public offering of only a specific, fixed number of redeemable securities called "units" and which will terminate and dissolve on a date specified at the creation of the UIT.

3. Exchange-Traded Funds (ETFs)

These are a type of investment company that aims to achieve the same return as a particular market index. They can be either open-end companies or UITs. But ETFs are not considered to be, and are not permitted to call themselves, mutual funds.

4. Characteristics of Mutual Funds

Some of the traditional, distinguishing characteristics of mutual funds include the following:

- ❑ Investors purchase mutual fund shares from the fund itself (or through a broker for the fund) instead of from other investors on a secondary market, such as the New York Stock Exchange or Nasdaq Stock Market;
- ❑ The price that investors pay for mutual fund shares is the fund's per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads);
- ❑ Mutual fund shares are "redeemable," meaning investors can sell their shares back to the fund (or to a broker acting for the fund);
- ❑ Mutual funds generally sell new shares to accommodate new investors. In other words, they sell their shares on a continuous basis, although some funds stop selling when, for example, they become too large; and
- ❑ The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisers" that are registered with the SEC.

C. HEDGE FUNDS

"Hedge fund" is a general, non-legal term used to describe private, unregistered investment pools that traditionally have been limited to sophisticated, wealthy investors. Hedge funds are not mutual funds and, as such, are not subject to the numerous regulations that apply to mutual funds for the protection of investors – including regulations requiring a certain degree of liquidity, regulations requiring that mutual fund shares be redeemable at any time, regulations protecting against conflicts of interest, regulations to assure fairness in the pricing of fund shares, disclosure regulations, regulations limiting the use of leverage, and more.

"Funds of hedge funds," a relatively new type of investment product, are investment companies that invest in hedge funds. Some, but not all, register with the SEC and file semi-annual reports. They often have lower minimum investment thresholds than traditional, unregistered hedge funds and can sell their shares to a larger number of investors. Like hedge funds, funds of hedge funds are not mutual funds. Unlike open-end mutual funds, funds of hedge funds offer very limited rights of redemption. And, unlike ETFs, their shares are not typically listed on an exchange.

D. DERIVATIVES

Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security, or index. Even small market movements can dramatically affect their value, sometimes in unpredictable ways.

There are many types of derivatives with many different uses. A fund's prospectus will disclose whether and how it may use derivatives. Investors may also want to call a fund and ask how it uses these instruments.

E. INDEX FUNDS

"Index fund" describes a type of mutual fund or Unit Investment Trust (UIT) whose investment objective typically is to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, the Russell 2000 Index, or the Wilshire 5000 Total Market Index.

An index fund will attempt to achieve its investment objective primarily by investing in the securities (stocks or bonds) of companies that are included in a selected index. Some index funds may also use derivatives (such as options or futures) to help achieve their investment objective. Some index funds invest in all of the companies included in an index; other index funds invest in a representative sample of the companies included in an index.

The management of index funds is more "passive" than the management of non-index funds, because an index fund manager only needs to track a relatively fixed index of securities. This usually translates into less trading of the fund's portfolio, more favorable income tax consequences (lower realized capital gains), and lower fees and expenses than more actively managed funds.

Because the investment objectives, policies, and strategies of an index fund require it to purchase primarily the securities contained in an index, the fund will be subject to the same general risks as the securities that are contained in the index. Those general risks are discussed in the descriptions of stock funds and bond funds. In addition, because an index fund tracks the securities on a particular index, it may have less flexibility than a non-index fund to react to price declines in the securities contained in the index.

Another type of investment company that attempts to track the performance of a market index is an exchange-traded fund (ETF). ETFs are legally classified as either UITs or open-end companies, but they differ from traditional UITs and open-end companies in a number of respects. For example, pursuant to SEC exemptive orders, shares issued by ETFs trade on a secondary market and are only redeemable in very large blocks (blocks of 50,000 shares, for example). ETFs are not considered to be, and may not call themselves, mutual funds.

F. ADVANTAGES AND DISADVANTAGES

Every investment has advantages and disadvantages. But it is important to remember that features that matter to one client may not be important to another. Whether any particular feature is an advantage for a particular client will depend on his or her unique circumstances. For some investors, mutual funds provide an attractive investment choice because they generally offer the following features.

1. Professional Management

Professional money managers research, select, and monitor the performance of the securities the fund purchases.

2. Diversification

Diversification is an investing strategy that can be neatly summed up as "Don't put all your eggs in one basket." Spreading investments across a wide range of companies and industry sectors can help lower the risk if a company or sector fails. Some investors find it easier to achieve diversification through ownership of mutual funds rather than through ownership of individual stocks or bonds.

3. Affordability

Some mutual funds accommodate investors who do not have a lot of money to invest by setting relatively low dollar amounts for initial purchases, subsequent monthly purchases, or both.

4. Liquidity

Mutual fund investors can readily redeem their shares at the current NAV – plus any fees and charges assessed on redemption – at any time.

But mutual funds also have features that some investors might view as disadvantages, such as:

- ❑ Investors must pay sales charges, annual fees, and other expenses (discussed below) regardless of how the fund performs. And, depending on the timing of their investment, investors may also have to pay taxes on any capital gains distribution they receive – even if the fund went on to perform poorly after they bought shares;
- ❑ Investors typically cannot ascertain the exact make-up of a fund's portfolio at any given time, nor can they directly influence which securities the fund manager buys and sells or the timing of those trades; and
- ❑ With an individual stock, investors can obtain real-time (or close to real-time) pricing information with relative ease by checking financial websites or by calling their broker. Investors can also monitor how a stock's price changes from hour to hour – or even second to second. By contrast, with a mutual fund, the price at which an investor purchases or redeems shares will typically depend on the fund's NAV, which the fund might not calculate until many hours after the investor has placed his or her order. In general, mutual funds must calculate their NAV at least once every business day, typically after the major U.S. exchanges close.

G. HOW MUTUAL FUNDS EARN MONEY FOR THEIR INVESTORS

Individuals can earn money from their investment in three ways:

1. Dividend Payments

A fund may earn income in the form of dividends and interest on the securities in its portfolio. The fund then pays its shareholders nearly all of the income (minus disclosed expenses) it has earned in the form of dividends.

2. Capital Gains Distributions

The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.

3. Increased NAV

If the market value of a fund's portfolio increases after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increases. The higher NAV reflects the higher value of the investment.

With respect to dividend payments and capital gains distributions, funds usually will give investors a choice: the fund can send them a check or other form of payment, or they can have their dividends or distributions reinvested in the fund to buy more shares (often without paying an additional sales load).

When it comes to investing in mutual funds, investors have literally thousands of choices. Before advising a client to invest in any given fund, decide whether the investment strategy and risks of the fund are a good fit. The first step to successful investing is figuring out your client's financial goals and risk tolerance.

H. TYPES OF FUNDS

Most mutual funds fall into one of three main categories – money market funds, bond funds (also called "fixed income" funds), and stock funds (also called "equity" funds). Each type has different features and different risks and rewards. Generally, the higher the potential return, the higher the risk of loss.

1. Money Market Funds

Money market funds have relatively low risks, compared to other mutual funds (and most other investments). By law, they can invest in only certain high-quality, short-term investments issued by the U.S. government, U.S. corporations, and state and local governments. Money market funds try to keep their net asset value (NAV) – which represents the value of one share in a fund – at a stable \$1.00 per share. But the NAV may fall below \$1.00 if the fund's investments perform poorly. Investor losses have been rare, but they are possible.

Money market funds pay dividends that generally reflect short-term interest rates, and historically the returns for money market funds have been lower than for either bond or stock funds. That is why "inflation risk" – the risk that inflation will outpace and erode investment returns over time – can be a potential concern for investors in money market funds.

2. Bond Funds

Bond funds generally have higher risks than money market funds, largely because they typically pursue strategies aimed at producing higher yields. Unlike money market funds, the SEC's rules do not restrict bond funds to high-quality or short-term investments.

Because there are many different types of bonds, bond funds can vary dramatically in their risks and rewards. Some of the risks associated with bond funds include:

- ❑ The possibility that companies or other issuers whose bonds are owned by the fund may fail to pay their debts (including the debt owed to holders of their bonds). Credit risk is less of a factor for bond funds that invest in insured bonds or U.S. Treasury bonds. By contrast, those that invest in the bonds of companies with poor credit ratings generally will be subject to higher risk;
- ❑ The risk that the market value of the bonds will go down when interest rates go up. Because of this, you can lose money in any bond fund, including those that invest only in insured bonds or Treasury bonds. Funds that invest in longer-term bonds tend to have higher interest rate risk; and
- ❑ The chance that a bond will be paid off early. For example, if interest rates fall, a bond issuer may decide to pay off (or "retire") its debt and issue new bonds that pay a lower rate. When this happens, the fund may not be able to reinvest the proceeds in an investment with as high a return or yield.

3. Stock Funds

Although a stock fund's value can rise and fall quickly (and dramatically) over the short term, historically stocks have performed better over the long term than other types of investments – including corporate bonds, government bonds, and treasury securities.

Overall "market risk" poses the greatest potential danger for investors in stocks funds. Stock prices can fluctuate for a broad range of reasons – such as the overall strength of the economy or demand for particular products or services.

Not all stock funds are the same. For example:

- ❑ Growth funds focus on stocks that may not pay a regular dividend but have the potential for large capital gains;
- ❑ Income funds invest in stocks that pay regular dividends;
- ❑ Index funds aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all – or perhaps a representative sample – of the companies included in an index; and
- ❑ Sector funds may specialize in a particular industry segment, such as technology or consumer products stocks.

I. BUYING AND SELLING SHARES

Investors can purchase shares in some mutual funds by contacting the fund directly. Other mutual fund shares are sold mainly through brokers, banks, financial planners, or insurance agents. All mutual funds will redeem shares on any business day and must send the payment within seven days.

When an investor buys shares, he or she pays the current NAV per share plus any fee the fund assesses at the time of purchase, such as a purchase sales load or other type of purchase fee. When an investor sells their shares, the fund will pay the NAV minus any fee the fund assesses at the time of redemption, such as a deferred (or back-end) sales load or redemption fee. A fund's NAV goes up or down daily as its holdings change in value.

A "family of funds" is a group of mutual funds that share administrative and distribution systems. Each fund in a family may have different investment objectives and follow different strategies.

Some funds offer exchange privileges within a family of funds, allowing shareholders to transfer their holdings from one fund to another as their investment goals or tolerance for risk change. While some funds impose fees for exchanges, most funds typically do not. To learn more about a fund's exchange policies, call the fund's toll-free number, visit its website, or read the "shareholder information" section of the prospectus.

Bear in mind that exchanges have tax consequences. Even if the fund does not charge the investor for the transfer, he or she will be liable for any capital gain on the sale of the shares – or, depending on the circumstances, eligible to take a capital loss.

II. Fees and Expenses

As with any business, running a mutual fund involves costs – including shareholder transaction costs, investment advisory fees, and marketing and distribution expenses. Funds pass along these costs to investors by imposing fees and expenses.

Some funds impose "shareholder fees" directly on investors whenever they buy or sell shares. In addition, every fund has regular, recurring, fund-wide "operating expenses." Funds typically pay their operating expenses out of fund assets – which means that investors indirectly pay these costs. SEC rules require funds to disclose both shareholder fees and operating expenses in a "fee table" near the front of a fund's prospectus.

A. SHAREHOLDER FEES

1. Sales Charge (Load) on Purchases

This is the amount an investor pays when buying shares in a mutual fund. Also known as a "front-end load," this fee typically goes to the brokers that sell the fund's shares. Front-end loads reduce the amount of the investment. For example, let's say John has \$1,000 and wants to invest it in a mutual fund with a 5% front-end load. The \$50 sales load John must pay comes off the top, and the remaining \$950 will be invested in the fund. According to the rules of the National Association of Securities Dealers, a front-end load cannot be higher than 8.5% of the investment.

2. Purchase Fee

This is another type of fee that some funds charge their shareholders when they buy shares. Unlike a front-end sales load, a purchase fee is paid to the fund (not to a broker) and is typically imposed to defray some of the fund's costs associated with the purchase.

3. Deferred Sales Charge (Load)

This is a fee an investor pays when he sells his shares. Also known as a "back-end load," this fee typically goes to the brokers that sell the fund's shares. The most common type of back-end sales load is the "contingent deferred sales load" (also known as a "CDSC" or "CDSL"). The amount of this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor holds his or her shares long enough.

4. Redemption Fee

This is another type of fee that some funds charge their shareholders when they sell or redeem shares. Unlike a deferred sales load, a redemption fee is paid to the fund (not to a broker) and is typically used to defray fund costs associated with a shareholder's redemption.

5. Exchange Fee

This is a fee that some funds impose on shareholders if they exchange (transfer) to another fund within the same fund group or "family of funds."

6. Account Fee

This is a fee that some funds separately impose on investors in connection with the maintenance of their accounts. For example, some funds impose an account maintenance fee on accounts whose value is less than a certain dollar amount.

B. ANNUAL FUND OPERATING EXPENSES

1. Management Fees

These are fees that are paid out of fund assets to the fund's investment adviser for investment portfolio management, any other management fees payable to the fund's investment adviser or its affiliates, and administrative fees payable to the investment adviser.

2. Distribution [and/or Service] Fees ("12b-1" Fees)

These are fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. "Distribution fees" include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature.

3. Shareholder Service Fees

These are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.

4. Other Expenses

These are expenses not included under "Management Fees" or "Distribution or Service (12b-1) Fees," such as any shareholder service expenses that are not already included in the 12b-1 fees, custodial expenses, legal and accounting expenses, transfer agent expenses, and other administrative expenses.

5. Total Annual Fund Operating Expenses ("Expense Ratio")

This is the line of the fee table that represents the total of all of a fund's annual fund operating expenses, expressed as a percentage of the fund's average net assets. Looking at the expense ratio can help investors make comparisons among funds.

C. "NO-LOAD" FUNDS

Some funds call themselves "no-load." As the name implies, this means that the fund does not charge any type of sales load. But, as discussed above, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds will also have operating expenses.

Investors should be sure to review carefully the fee tables of any funds they are considering, including no-load funds. Even small differences in fees can translate into large differences in returns over time.

Example.

If Austin invested \$10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years he would have roughly \$49,725. But if the fund had expenses of only 0.5%, then he would end up with \$60,858 – an 18% difference.

D. BREAKPOINTS

Some mutual funds that charge front-end sales loads will charge lower sales loads for larger investments. The investment levels required to obtain a reduced sales load are commonly referred to as "breakpoints."

The SEC does not require a fund to offer breakpoints in the fund's sales load. But, if breakpoints exist, the fund must disclose them. In addition, a brokerage firm that is a member of the NASD (formerly known as the National Association of Securities Dealers) should not sell an investor shares of a fund in an amount that is "just below" the fund's sales load breakpoint simply to earn a higher commission. Each fund company establishes its own formula for how they will calculate whether an investor is entitled to receive a breakpoint.

III. Tax Consequences of Mutual Funds

A. GENERAL RULES

When an investor buys and holds an individual stock or bond, they must pay income tax each year on the dividends or interest received. But they will not have to pay any capital gains tax until they actually sell and unless they make a profit. Mutual funds are different.

When an investor buys and holds mutual fund shares, they will owe income tax on any ordinary dividends in the year they receive or reinvest them. And, in addition to owing taxes on any personal capital gains when they sell their shares, they may also have to pay taxes each year on the fund's capital gains. That is because the law requires mutual funds to distribute capital gains to shareholders if they sell securities for a profit that cannot be offset by a loss.

Bear in mind that if an investor receives a capital gains distribution, they will likely owe taxes – even if the fund has had a negative return from the point during the year when the individual investor purchased their shares. For this reason, investors should call the fund to find out when it makes distributions so they will not pay more than your fair share of taxes. Some funds post that information on their websites.

With investments in a tax-exempt fund – such as a municipal bond fund – some or all of the dividends will be exempt from federal (and sometimes state and local) income tax. Investors will, however, owe taxes on any capital gains.

SEC rules require mutual funds to disclose in their prospectuses after-tax returns. In calculating after-tax returns, mutual funds must use standardized formulas similar to the ones used to calculate before-tax average annual total returns. When comparing funds, investors need to take taxes into consideration.

B. TAX TREATMENT OF DISTRIBUTIONS

A distribution an individual receives from a mutual fund may be an ordinary dividend, a qualified dividend, a capital gain distribution, an exempt-interest dividend, or a nontaxable return of capital. The fund will send investors a Form 1099-DIV or similar statement telling them the kind of distribution they received. In some cases, an investor may be treated as having received a distribution of capital gains even if the fund does not distribute them.

C. ORDINARY DIVIDENDS

An ordinary dividend is a distribution by a mutual fund out of its earnings and profits. Ordinary dividends that an investor receives from a mutual fund are included as dividend income on an individual's income tax return. Ordinary dividends are the most common type of dividends. They will be reported in box 1a of Form 1099-DIV or on a similar statement investors receive from the mutual fund.

D. QUALIFIED DIVIDENDS

Qualified dividends are taxed at the same lower rates that apply to a net capital gain. They are taxed at 15% if the regular tax rate that would apply is 25% or higher. They are taxed at 5% if the regular tax rate that would apply is 10% or 15%. To be a qualified dividend subject to the 5% or 15% rate, a dividend must meet all of the following requirements.

- ❑ The dividend must have been paid by a U.S. corporation or a qualified foreign corporation;
- ❑ The dividend must not be of a type excluded by law from the definition of a qualified dividend; and
- ❑ The investor must meet the holding period requirement, discussed below.

The investor must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock will not receive the next dividend payment. Instead, the seller will get the dividend. When counting the number of days the stock was held, the day the stock was disposed of should be included, but not the day it was acquired.

E. CAPITAL GAIN DISTRIBUTIONS

These distributions are paid by mutual funds from their net realized long-term capital gains. The Form 1099-DIV (box 2a) investors receive or the fund's statement will tell them the amount they are to report as a capital gain distribution. Capital gain distributions are taxed as long-term capital gains regardless of how long an investor has owned the shares in the mutual fund.

Mutual funds may keep some of their long-term capital gains and pay taxes on those undistributed amounts. Investors must report their share of these amounts as long-term capital gains, even though they did not actually receive a distribution. The investors can take a credit for any tax paid because they are considered to have paid it. When an investor reports undistributed capital gains from a mutual fund, they must increase their basis in the shares.

1. Exempt-Interest Dividends

A mutual fund may pay exempt-interest dividends to its shareholders if it meets certain requirements. These dividends are paid from tax-exempt interest earned by the fund. Since the exempt-interest dividends keep their tax-exempt character, they are not included as income. However, investors may need to report them on their return. The mutual fund will send investors a statement within 60 days after the close of its tax year showing their exempt-interest dividends. Exempt-interest dividends are not shown on Form 1099-DIV.

Although exempt-interest dividends are not taxable, investors must report them on their tax return if they are required to file. This is an information reporting requirement and does not convert tax-exempt interest to taxable interest. Also, this income is generally a “tax preference item” and may be subject to the alternative minimum tax.

2. Return of Capital (Nontaxable) Distributions

A distribution that is not out of earnings and profits is a return of investment, or capital, in the mutual fund and is shown in box 3 of Form 1099-DIV. These returns of capital distributions are generally not taxed and are sometimes called tax-free dividends or nontaxable distributions.

A return of capital distribution reduces an investor's basis in the shares. An investor's basis cannot be reduced below zero. If an investor's basis is zero, they must report the return of capital distribution on their tax return as a capital gain. Whether it is a long-term or short-term capital gain depends on how long the investor held the shares.

Example.

Liz bought shares in a mutual fund in 2004 for \$12 a share. In 2005, Liz received a return of capital distribution of \$5 a share. She reduced her basis in each share by \$5 to an adjusted basis of \$7. In 2006, Liz received a return of capital distribution of \$1 per share and further reduced her basis in each share to \$6. In 2007, Liz received a return of capital distribution of \$2 per share. Her basis was reduced to \$4. In 2008, the return of capital distribution from the mutual fund was \$5 a share. Liz reduces her basis in each share to zero and report the excess (\$1 per share) as a long-term capital gain on Schedule D.

3. Reinvestment of Distributions

Most mutual funds permit shareholders to automatically reinvest distributions in more shares in the fund, instead of receiving cash. Investors must report the reinvested amounts the same way as they would report them if they received them in cash. This means that reinvested ordinary dividends and capital gain distributions generally must be reported as income. Reinvested exempt-interest dividends generally are not reported as income.

F. FOREIGN TAX DEDUCTION OR CREDIT

Some mutual funds invest in foreign securities or other instruments. A mutual fund may choose to allow an investor to claim a deduction or credit for the taxes it paid to a foreign country or U.S. possession. The fund will notify investors if this applies. The notice will include each investor's share of the foreign taxes paid to each country or possession and the part of the dividend derived from sources in each country or possession.

IV. Tracking Basis

It is impossible to determine an investor's tax liability without understanding their basis in an investment. Investors should therefore keep track of their basis in mutual fund shares to figure any gain or loss on the shares when they sell, exchange, or redeem them.

A. TYPES OF BASIS

1. Original Basis

Original basis depends on how an investor acquired their shares.

2. Adjusted Basis

An investor's original basis is adjusted (increased or decreased) by certain events.

3. Shares Acquired by Purchase

The original basis of mutual fund shares an investor purchased is usually their cost or purchase price. The purchase price usually includes any commissions or load charges paid for the purchase.

Example.

Rich bought 100 shares of Fund A for \$10 a share. He paid a \$50 commission to the broker for the purchase. His cost basis for each share is \$10.50 ($\$1,050 \div 100$).

When buying or selling shares in a fund, investors should keep the confirmation statements they receive. The statements show the price paid for the shares when they were bought, and the price received when they were sold. The information from the confirmation statement when the investor purchased the shares will help them calculate their basis in the fund.

B. COMMISSIONS AND LOAD CHARGES

The fees and charges an investor pays to acquire or redeem shares of a mutual fund are not deductible. Investors can usually add acquisition fees and charges to their cost of the shares and thereby increase their basis. A fee paid to redeem the shares is usually a reduction in the redemption price (sales price).

Investors cannot add their entire acquisition fee or load charge to the cost of the mutual fund shares acquired if all of the following conditions apply:

- ☐ The individual receives a reinvestment right because of the purchase of the shares or the payment of the fee or charge;
- ☐ The individual disposes of the shares within 90 days of the purchase date;

- ❑ The individual acquires new shares in the same mutual fund or another mutual fund, for which the fee or charge is reduced or waived because of the reinvestment right the individual received when they acquired the original shares; and
- ❑ The amount of the original fee or charge in excess of the reduction above is added to the cost of the original shares. The rest of the original fee or charge is added to the cost basis of the new shares (unless all three conditions above also apply to the purchase of the new shares).

C. REINVESTMENT RIGHTS

This is the right to acquire mutual fund shares in the same or another mutual fund without paying a fee or load charge, or by paying a reduced fee or load charge.

The original cost basis of mutual fund shares acquired by reinvesting distributions is the amount of the distributions used to purchase each full or fractional share. This rule applies even if the distribution is an exempt-interest dividend that the investor does not report as income.

When an investor acquires shares through reinvestment, they should keep the statements that show each date, amount, and number of full or fractional shares purchased.

D. SHARES RECEIVED AS GIFT

Generally, an investor must know the basis per share to compute gain or loss when they dispose of the shares. To determine the original basis of mutual fund shares an individual acquired by gift, they must know:

- ❑ The donor's adjusted basis;
- ❑ The date of the gift;
- ❑ The fair market value (the last quoted public redemption price) of the shares at the time of the gift; and
- ❑ Any gift tax paid on the gift of the shares.

If the fair market value (FMV) of the shares at the time of the gift was less than the adjusted basis to the donor at the time of the gift, the recipient's basis for gain on their disposition is the donor's adjusted basis. The recipient's basis for loss is the FMV of the shares at the time of the gift. In this situation, it is possible to sell the shares at neither a gain nor a loss because of the basis the recipient has to use.

Example.

Justin is given mutual fund shares with an adjusted basis of \$10,000 at the time of the gift. The FMV of the shares at the time of the gift is \$9,000. Justin later sells the shares for \$9,500. The basis for figuring a gain is \$10,000, so there is no gain. There also is no loss, since the basis for figuring a loss is \$9,000. In this situation, Justin neither has a gain nor a loss.

If the FMV of the shares at the time of the gift was equal to or more than the donor's adjusted basis at the time of the gift, the recipient's basis is the donor's adjusted basis at the time of the gift, plus all or part of any gift tax paid on the gift, depending on the date of the gift.

E. SHARES ACQUIRED BY INHERITANCE

If an individual inherited shares in a mutual fund, their original basis is generally the fair market value (FMV) (the last quoted public redemption price) on the date of the decedent's death, or the alternate valuation date if chosen for estate tax purposes.

In community property states, an individual and their spouse generally are considered to each own half the estate (excluding separate property). If one spouse dies and at least half of the community interest is includible in the decedent's gross estate (whether or not the estate is required to file a return), the FMV of the community property at the date of death becomes the basis of both halves of the property. For example, if the FMV of the entire community interest in a mutual fund is \$100,000, the basis of the surviving spouse's half of the shares is \$50,000. The basis of the heirs' half of the shares also is \$50,000.

In determining the basis of assets acquired from a decedent, property held in joint tenancy is community property if its status was community property under state law.

A different basis rule applies to inherited shares that an individual and their spouse gave the decedent within the 1-year period ending on the date of the decedent's death if, on the date of the gift, the shares were appreciated property. In this situation, the basis of the inherited shares is the decedent's adjusted basis in them immediately before his or her death, rather than their FMV.

This basis rule also applies if the decedent's estate (or a trust of which the decedent was the grantor) sells the shares instead of distributing them to an individual, and that individual is entitled to the proceeds.

F. ADJUSTED BASIS

After an investor acquires mutual fund shares, they may need to make adjustments to their basis. The adjusted basis of an investor's shares is their original basis increased or reduced as described here.

1. Addition to Basis

Investors should increase the basis in their shares by the difference between the amount of undistributed capital gain they include in income and the tax considered paid on that income. The mutual fund reports the amount of an investor's undistributed capital gain in box 1a of Form 2439. Investors should keep Copy C of all Forms 2439 to show increases in the basis of their shares.

2. Reduction of Basis

Investors must reduce their basis in shares by any return of capital distributions that they receive from the fund. The mutual fund reports the amount of any return of capital distributions in box 3 of Form 1099-DIV. Investors should keep the form to show the decrease in the basis of their shares.

3. No Reduction of Basis

Investors should not reduce their basis for distributions from the fund that are exempt-interest dividends.

Table 7-1. Mutual Fund Record

The following worksheet can be used to keep track of the adjusted basis of mutual fund shares. Investors should enter the cost per share when they acquire new shares and any adjustments to their basis when the adjustment occurs. This worksheet will help calculate the adjusted basis when the investor sells or redeems shares.

Mutual Fund	Acquired ¹			Adjustment to Basis Per Share	Adjusted ² Basis Per Share	Sold or redeemed	
	Date	Number of Shares	Cost Per Share			Date	Number of Shares

¹ Include shares received from reinvestment of distributions.

² Cost plus or minus adjustments.

G. SALES, EXCHANGES AND REDEMPTIONS

When an investor sells or exchanges their mutual fund shares, or if they are redeemed (a redemption), they will generally have a taxable gain or a deductible loss. This also applies to shares of a tax-exempt mutual fund. Sales, exchanges, and redemptions are all treated as sales of capital assets. The amount of the gain or loss is the difference between an investor's adjusted basis in the shares and the amount realized from the sale, exchange, or redemption.

1. Sale

In general, a sale is a transfer of shares for money only.

2. Exchange

An exchange is a transfer of shares in return for other shares.

3. Redemption

A redemption occurs when a fund reacquires its shares from an investor in exchange for money or other property.

Any exchange of shares in one fund for shares in another fund is a taxable exchange. This is true even if an investor exchanges shares in one fund for shares in another fund within the same family of funds.

V. Identifying the Shares Sold

To figure a gain or loss when disposing of mutual fund shares, an investor needs to determine which shares were sold and the basis of those shares. If an investor's shares in a mutual fund were acquired all on the same day and for the same price, figuring their basis is not difficult. However, shares are generally acquired at various times, in various quantities, and at various prices. Therefore, calculating the basis can be a difficult task. Investors can choose to use either a cost basis or an average basis to figure their gain or loss.

A. COST BASIS

Investors can calculate their gain or loss using a cost basis only if they did not previously use an average basis for a sale, exchange, or redemption of other shares in the same mutual fund. To figure cost basis, investors can choose one of the following methods:

- ☐ Specific share identification; or
- ☐ First-in first-out (FIFO).

1. Specific Share Identification

If an investor adequately identifies the shares they sold, they can use the adjusted basis of those particular shares to figure their gain or loss. An investor will adequately identify their mutual fund shares, even if they bought the shares in different lots at various prices and times, if they:

- ❑ Specify to their broker or other agent the particular shares to be sold or transferred at the time of the sale or transfer; and
- ❑ Receive confirmation in writing from their broker or other agent within a reasonable time of their specification of the particular shares sold or transferred.

An investor continues to have the burden of proving their basis in the specific shares at the time of sale or transfer.

2. First-in First-Out (FIFO)

If an investor's shares were acquired at different times or at different prices and they cannot identify which shares they sold, they should use the basis of the shares they acquired first as the basis of the shares sold. In other words, the oldest shares an investor owns are considered sold first. Investors should keep a separate record of each purchase and any dispositions of the shares until all shares purchased at the same time have been disposed of completely.

B. AVERAGE BASIS

An investor can calculate their gain or loss using an average basis only if they acquired the shares at various times and prices, and they left the shares on deposit in an account handled by a custodian or agent who acquires or redeems those shares.

To figure average basis, an investor can use one of the following methods:

- ❑ Single-category method; or
- ❑ Double-category method.

Once an investor elects to use an average basis, they must continue to use it for all accounts in the same fund. (They must also continue to use the same method.) However, an investor may use the cost basis (or a different method of figuring the average basis) for shares in other funds, even those within the same family of funds.

Example.

Lex owns two accounts that hold shares of the income fund issued by Company A. Lex also owns 100 shares of the growth fund issued by Company A. If Lex elects to use average basis for the first account of the income fund, they must use average basis for the second account. However, Lex may use cost basis for the growth fund.

1. Single-Category Method

Under the single-category method, an investor finds the average basis of all shares owned at the time of each disposition, regardless of how long they owned them.

Even though investors include all unsold shares of a fund in a single category to compute average basis, they may have both short-term and long-term gains or losses when they sell these shares. To determine a holding period, the shares disposed of are considered to be those acquired first.

Example.

Tammy bought 400 shares in the LJO Mutual Fund: 200 shares on May 15, 2006, and 200 shares on May 15, 2007. On November 11, 2007, Tammy sold 300 shares. The basis of all 300 shares sold is the same, but she held 200 shares for more than 1 year, so her gain or loss on those shares is long-term. Tammy held 100 shares for one year or less, so her gain or loss on those shares is short-term.

2. Double-Category Method

In the double-category method, all shares in an account at the time of each disposition are divided into two categories: short-term and long-term. Shares held 1 year or less are short-term. Shares held longer than 1 year are long-term.

The basis of each share in a category is the average basis for that category. This is the total remaining basis of all shares in that category at the time of disposition divided by the total shares in the category at that time. To use this method, an investor must specify, to the custodian or agent handling their account, from which category the shares are to be sold or transferred. The custodian or agent must confirm in writing the specification. If an investor does not specify or receive confirmation, they must first charge the shares sold against the long-term category and then charge any remaining shares sold against the short-term category.

3. Changing Categories

After an investor has held a mutual fund share for more than 1 year, they must transfer that share from the short-term category to the long-term category. The basis of a transferred share is its actual cost or other basis to that individual unless some of the shares in the short-term category have been disposed of. In that case, the basis of a transferred share is the average basis of the undisposed shares at the time of the most recent disposition from this category.

4. Making the Choice

An investor chooses to use the average basis of mutual fund shares by clearly showing on their income tax return, for each year the choice applies, that they used an average basis in reporting gain or loss from the sale or transfer of the shares. An investor must specify whether they used the single-category method or the double-category method in determining average basis. This choice is effective until permission is received from the IRS to revoke it.

Table 7-2. Example of How To Figure Basis of Shares Sold

This is an example showing two different ways to figure basis. It compares the cost basis using the FIFO method with the average basis using the single-category method.

Date	Action	Share Price	No. of Shares	Total Shares Owned
02/05/06	Invest \$4,000	\$25	160	160
08/06/06	Invest \$4,800	\$20	240	400
12/17/06	Reinvest \$300 dividend	\$30	10	410
09/30/07	Sell 210 shares for \$6,720	\$32	210	200

COST BASIS (FIFO)	<p>To figure the basis of the 210 shares sold on 09/30/08, use the share price of the first 210 shares you bought, namely, the 160 shares you purchased on 02/05/07 and 50 of those purchased on 08/06/07.</p> <p>\$4,000 (cost of 160 shares on 02/05/07) <u>+1,000</u> (cost of 50 shares of 08/06/07) \$5,000 = Basis</p>
AVERAGE BASIS (single-category)	<p>To figure the basis of the 210 shares sold on 09/30/08, use the average basis of all 410 shares owned on 09/30/08.</p> <p>\$9,100 (cost of 410 shares) <u>÷ 410</u> (number of shares) \$22.20 (average basis per share)</p> <p>\$22.20 <u>x 210</u> \$4,662 = basis</p>

CHAPTER 7 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The most common investment for Americans looking to put money into equities is:
 - a) individual corporate stocks
 - b) mutual funds
 - c) hedge funds
 - d) corporate bonds
2. Which of the following statements best describes a “hedge fund”:
 - a) they are registered investment funds that are common investment tools for middle income Americans
 - b) they are unregistered investment funds usually limited to wealthy and sophisticated investors
 - c) they are highly regulated investment pools typically limited to wealthy investors
 - d) they are investment trusts that purchase government securities
3. Mutual funds do not have any fees associated with them.
 - a) true
 - b) false
4. Which of the following statements about bond funds is correct:
 - a) they generally have lower risk than money market funds
 - b) they generally have higher risk associated with them than money market funds
 - c) they are subject to restrictions on the quality of their investments
 - d) all of the above
5. There is no limit to the amount of sales charge that can be charged on a mutual fund investment.
 - a) true
 - b) false
6. A no-load fund does not charge any type of sales load or fees.
 - a) true
 - b) false

7. When an investor reinvests mutual fund distributions, such distributions:
- a) are not subject to income tax so long as 100% of the distribution is reinvested
 - b) must be reported as income to the same extent as if they received a cash distribution
 - c) must be reported as income, although the taxpayer receives a deduction to the extent the money is reinvested in the same mutual funds
 - d) is exempt from state but not federal income tax
8. The original basis of shares depends on how they were acquired.
- a) true
 - b) false
9. An investor's basis in mutual fund shares received as a gift will always be the fair market value of the shares on the date received.
- a) true
 - b) false
10. How do taxpayers calculate the basis of mutual fund shares for purposes of federal income tax:
- a) they must average the purchase price of all shares
 - b) they may choose from several methods to calculate their gain or loss
 - c) they must use the first-in-first-out method
 - d) there is no need to calculate basis as the earnings are not subject to income or capital gains taxes

CHAPTER 7 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Most Americans who put money into equities do so through shares in mutual funds. This means they do not have to choose individual stocks in which to invest.

B: Correct. Most Americans put their money into mutual funds because they offer the chance to invest in equities with professional management.

C: Incorrect. This type of investment is usually limited to the very rich and sophisticated investor.

D: Incorrect. Bonds are notes of indebtedness, not equities.

(See page 7-1 of the course material.)

2. A: Incorrect. These funds are not registered and tend to cater to high income people with a high degree of financial sophistication.

B: Correct. These are purely private, unregistered funds that have traditionally been limited to the wealthy. They are not highly regulated like mutual funds, and therefore do not offer the same type of investor protections as the more traditional mutual funds.

C: Incorrect. While they are usually the vehicle of the wealthy, they are not highly regulated.

D: Incorrect. They generally purchase corporate stocks, and are not trusts.

(See page 7-2 of the course material.)

3. A: True is incorrect. Investors generally have to pay sales charges, annual fees, and other expenses regardless of how the fund performs.

B: False is correct. In addition to sales charges, annual fees, and other expenses, some investors may also have to pay taxes on any capital gains distribution they receive, even if the fund went on to perform poorly after they purchased shares.

(See page 7-4 of the course material.)

4. A: Incorrect. Just the opposite is true. They have higher risk because they typically pursue high yielding investment options.

B: Correct. This is true because the investment strategies employed are aimed at producing higher yields.

C: Incorrect. The SEC does not impose this type of restriction on bond funds.

D: Incorrect. Both A and C are incorrect, so D cannot be true.

(See pages 7-5 to 7-6 of the course material.)

5. A: True is incorrect. According to the rules of the National Association of Securities Dealers (NASD), a front-end load (sales charge) cannot be higher than 8.5% of the investment.

B: False is correct. Sales charges are limited to no more than 8.5% of the investment according to the NASD. This front-end fee reduces the amount of the investment, and typically goes to the brokers that sell the fund's shares.

(See page 7-7 of the course material.)

6. A: True is incorrect. A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees.

B: False is correct. A no-load fund does not charge any type of sales load, but may charge other fees. No-load funds also will have operating expenses. All funds should be reviewed carefully prior to purchase, because even a small difference in fees can translate into a large difference in returns over time.

(See page 7-9 of the course material.)

7. A: Incorrect. The reinvested distribution is indeed income subject to federal income tax.

B: Correct. This is true even if the distributions are automatically reinvested and never seen by the shareholder.

C: Incorrect. There is no such deduction. The money must be reported and is subject to income tax.

D: Incorrect. The money is subject to both federal and where applicable, state income tax.

(See page 7-12 of the course material.)

8. **A: True is correct.** The original basis of mutual fund shares acquired by purchase is usually their cost or purchase price. The purchase price usually includes any commissions or load charges paid for the purchase.

B: False is incorrect. Investors need to keep track of their basis in mutual fund shares to figure any gain or loss on the shares when they sell, exchange, or redeem them. The original basis for mutual fund shares acquired by purchase is usually the purchase price, including any commissions or load charges paid for the purchase.

(See page 7-13 of the course material.)

9. A: True is incorrect. The recipient's basis for a loss is the FMV of the shares at the time of the gift, but the basis for a gain would be the donor's adjusted basis. It is possible to sell mutual fund shares at neither a gain nor a loss because of the basis the recipient has to use.

B: False is correct. The basis the investor uses depends on whether the mutual fund shares are being sold at a gain or a loss.

(See pages 7-14 to 7-15 of the course material.)

10. A: Incorrect. In some cases, the correct method is to average the price of all shares. However, this is only an option where the shares were purchased at different times.

B: Correct. There are several methods for making such a calculation depending on the circumstances of each individual shareholder. For example, taxpayers can use the first-in-first-out or specific share identification methods.

C: Incorrect. This method can be used where the shares were acquired at different times or at different prices, but is not mandatory in every case.

D: Incorrect. Such gains are indeed taxable.

(See pages 7-17 to 7-18 of the course material.)

Chapter 8: Taxation of Business Entities

I. Introduction and Overview

For individuals who own their own business, good financial planning includes selecting the appropriate type of entity for that business. There are many factors that go into choosing a type of business entity, but federal taxes, most notable self-employment tax and income tax, are certainly an important component of that consideration.

For purposes of federal tax, the law sets forth three basic models of taxation of businesses and individuals: subchapter C, subchapter K and subchapter S. Subchapter C applies to corporations. It imposes an entity level tax on the corporation as well as a tax on individual shareholders who receive corporate distributions (i.e. dividends).

Table 8-1. Business Form and Taxation: Advantages and Disadvantages

BUSINESS FORM	ADVANTAGE(S)	DISADVANTAGE(S)
Sole Proprietorship	No “double taxation”; income reported on individual return	Owner pays twice the amount of Social Security and Medicare tax than he would as an employee
Limited Liability Company	IRS “check-the-box” regulations allow entity to choose federal tax treatment	Active members subject to self-employment tax for Social Security and Medicare
Partnership	No “double taxation”; income taxed proportionately to each partner on their own personal returns	No personal limited liability protection for general partners
S Corporation	May elect to be treated similar to a partnership for purposes of federal taxation, so income is “passed through” to shareholders	Shareholders entitled to only limited employee benefits; limited to no more than 100 shareholders
C Corporation	Corporate tax rate does not go as high as individual tax rate; health insurance and group life insurance premiums (up to certain amount) are fully deductible and not taxable to employees	Shareholders not entitled to deduct the losses of the corporation; “double taxation”

Subchapter S status is available to C corporations that meet certain strict statutory requirements. It allows shareholders or relatively small corporations to avoid entity-level taxation: similar to partnership treatment, all of the profits and losses of the corporation are passed through to the individual shareholders.

Finally, subchapter K applies to partnerships, limited liability companies and certain other unincorporated entities. Like S corporations, owners are allowed to elect pass-through taxation. Partnerships are not subject to the income tax. However, a partnership is required to file Form 1065, which reports the results of the partnership's business activities. Individual partners pay taxes on their individual returns.

The partnership net profit (loss) and the separately reported items are allocated to each partner according to the partnership's profit sharing agreement, and the partners receive separate K-1 schedules from the partnership. Schedule K-1 reports each partner's share of the partnership net profit and separately reported income and expense items. Each partner reports these items on his or her own tax return.

The two types of federal taxation that are most frequently considered in making a choice of entity are income tax and self-employment tax. Rules regarding income taxation of specific entities will be discussed later. Following is a discussion of self-employment tax and its application in choice of entity.

A. SELF-EMPLOYMENT TAX

Self-employment tax is a social security and Medicare tax that mainly affects persons who work for themselves. Many people consider ways to avoid self-employment taxes when considering a choice of entity. The reason is that the self-employment tax rate is 15.3%. This rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). There is, however, a cap on the amount of income that is subject to the social security tax portion. In 2009, for example, up to \$106,800 of combined net earnings is subject to social security tax. Taxpayers can deduct half of their self-employment tax in figuring adjusted gross income; however, the adjustment does not affect the amount of self-employment tax actually owed.

SOCIAL SECURITY AND MEDICARE TAXES		
Social Security Taxes	2008	2009
Employee/employer (each)	6.2% on earnings up to \$102,000	6.2% on earnings up to \$106,800
Self-employed	12.4%* on earnings up to \$102,000	12.4%* on earnings up to \$106,800
Medicare Taxes	2008	2009
Employee/employer (each)	1.45% on all earnings	1.45% on all earnings
Self-employed	2.9%* on all earnings	2.9%* on all earnings

*Can be offset by income tax provisions

The IRS considers the following groups of people to be self-employed and therefore subject to self-employment tax:

- ☐ Persons who carry on a trade or business as a sole proprietor or an independent contractor;
- ☐ Members of a partnership that carries on a trade or business; and
- ☐ Persons who are otherwise in business for themselves.

A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit. The facts and circumstances of each case determine whether or not an activity is a trade or business. The regularity of activities and transactions and the production of income are important elements. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business.

1. Part-time business

An individual does not have to carry on regular full-time business activities to be self-employed. Having a part-time business in addition to a regular job or business may also be self-employment.

Example.

Bill is employed full time as an engineer at the local plant. He fixes televisions and radios during the weekends. Bill has his own shop, equipment, and tools. He gets his customers from advertising and word-of-mouth. Bill is self-employed as the owner of a part-time repair shop.

2. Sole proprietor

An individual is a sole proprietor if they are the sole owner of an unincorporated business.

3. Independent contractor

People such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, or auctioneers who are in an independent trade, business, or profession in which they offer their services to the general public are generally independent contractors. However, whether these people are independent contractors or employees depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done. The earnings of a person who is working as an independent contractor are subject to SE tax.

An individual is not an independent contractor if they perform services that can be controlled by an employer (what will be done and how it will be done). This applies even if an individual is given freedom of action. What matters is that the employer has the legal right to control the details of how the services are performed.

If an employer-employee relationship exists (regardless of what the relationship is called), the individual is not an independent contractor and their earnings are generally not subject to SE tax. However, their earnings as an employee may be subject to SE tax under other rules discussed in this section.

B. SOLE PROPRIETORS

A sole proprietorship has no existence separate and apart from its owner. It does not file a tax return and is not liable for taxes. The proprietor himself is liable for all of the profits and losses of the business. A sole proprietor is required to report all net profits from the

business, whether they are retained in the business' account or not. The individual reports his income on Schedule C of Form 1040.

Sole proprietors are, as mentioned above, subject to self-employment tax on business profits. Because a sole proprietor is not an employee, no deduction is permitted for fringe benefits offered by the business. A sole proprietor, however, may deduct 100 percent of insurance premiums paid in taxable years beginning in the calendar year 2003 for accident and health insurance for the sole proprietor and the proprietor's spouse and dependents.

In fact, a sole proprietor may deduct 100 percent of insurance premiums paid for accident and health insurance, as well as medical reimbursements, for the sole proprietor and the proprietor's spouse and dependents if the sole proprietor provides the coverage to his or her spouse who is an employee of the business. The spouse may exclude the premium payments from income and/or any medical expense reimbursements, provided that the spouse is a bona fide employee of the business. However, if the spouse is self-employed (e.g., a partner) in the business, the accident and health insurance premiums and/or medical expense reimbursements, while deductible by the proprietorship, are included in the spouse's income and may be deducted by the spouse to the extent allowed to a sole proprietor.

II. Disregarded Entities: The Limited Liability Company

Historically, businesses had to choose between the protection from liability offered by the corporation and the pass-through taxation offered by the partnership or sole proprietorship. This has changed dramatically over the past few decades.

Today, all 50 states allow a business to choose limited liability company (LLC) status and limited liability partnerships (LLP), which essentially allow *all* partners the protections of limited partner status in a general partnership. Each state has its own specific laws that determine what types of partnerships are eligible and the scope of limited liability offered.

A. HISTORICAL TREATMENT

One of the many benefits of limited liability company status is the ability of the owners to elect pass-through taxation. But when the IRS first recognized the existence of LLCs as a business form, not all LLCs were able to qualify for pass-through tax status. Federal regulations in place prior to 1997 required an unincorporated business entity – whether it be a limited liability company or a partnership -- to possess certain characteristics or else it was treated as a corporation for federal tax purposes.

Under the old regulations (known as the “Kintner Regulations”), an unincorporated business association would be taxed as a partnership *only* if it possessed no more than two of the following corporate characteristics:

- ❑ Centralization of management;
- ❑ Continuity of life;

- ❑ Free transferability of interests; and
- ❑ Limited liability.

The continuing of life restriction was the biggest impediment to limited liability companies being taxed as partnerships. It led most early state statutes governing limited liability companies to impose time limitations on the existence of the entity in order to protect its pass-through tax status. That all changed with the adoption of the so-called “check-the-box” regulations by the IRS.

Check-the-box regulations became effective in 1997, eliminating application of the so-called Kintner regulations that had previously been used to determine if a business association should be treated as a partnership or corporation for purposes of federal taxation. The key change was the elimination of the requirement that a limited liability company have a limited life span in order to qualify for pass-through taxation (under the old regulation, a company with an unlimited life span was too similar to a corporation to avoid being taxed as such).

The changes also made possible more flexibility in other types of unincorporated business associations, such as limited liability partnerships.

B. FEDERAL TAX RETURNS

For federal tax purposes, a limited liability company can be treated as either a sole proprietorship, a partnership or a corporation. In order to elect treatment as a partnership, a limited liability company must have at least two members. Those with only one can elect to be treated either as a sole proprietorship or a corporation.

Consequently, the applicable tax payment requirements of a limited liability company depend on the tax treatment elected by the company. To the extent that a limited liability company elects to be treated as a partnership for purposes of federal taxation, normal rules governing taxation of partnerships apply. To the extent a limited liability company elects to be treated as a corporation for purposes of federal taxation, normal rules governing taxation of corporations likewise generally apply. An in-depth discussion of partnership and corporation taxation is well beyond the scope of this course. This section will therefore be limited to a discussion of a few significant areas of taxation affecting limited liability companies.

Even though a co-owned LLC itself does not pay income taxes, it must file Form 1065 with the IRS. This form, the same one that a partnership files, is an informational return that the IRS reviews to make sure the LLC members are reporting their income correctly. The LLC must also provide each LLC member with a "Schedule K-1," which breaks down each member's share of the LLC's profits and losses. In turn, each LLC member reports this profit and loss information on his individual Form 1040, with Schedule E attached. The check-the-box regulations give limited liability companies flexibility in deciding how they want to be taxed and therefore what type of tax return to file.

1. Single-Member LLC

Generally, when an LLC has only one member, the fact that it is an LLC is ignored or “disregarded” for the purpose of filing a federal tax return. The LLC has the following options for purposes of federal taxation:

- ❑ If the only member of the LLC is an individual, the LLC income and expenses are reported on Form 1040, Schedule C, E, or F;
- ❑ If the only member of the LLC is a corporation, the LLC income and expenses are reported on the corporation’s return, usually Form 1120 or Form 1120S; and
- ❑ If a single-member LLC wishes to file as a corporation instead of as a “disregarded entity,” Form 8832 must be submitted. Otherwise, there is no need to file Form 8832. Single-member LLCs may not file a partnership return.

For a single-member LLC being disregarded as an entity, the taxable year of the proprietor (usually the calendar year) is automatically the taxable year of the proprietorship. There are tax-deductible fringe benefits available to a sole proprietor, although they are more limited than those available to a corporation. A sole proprietor may contribute annually to a Keogh plan to the same limits available under corporate plans, and a proprietor may contribute to an individual retirement account. A sole proprietor may not deduct the cost of premiums for insurance on his or her own life but may deduct a portion of the cost of health insurance premiums for himself or herself and dependents, subject to certain limitations. A sole proprietorship may deduct 100 percent of a sole proprietor's health insurance premiums beginning in 2003 pursuant to I.R.C. § 162(e)(1). Deductions for premiums paid for group term life insurance and health insurance for employees of a sole proprietorship are available to the same extent as though incurred by a corporation.

2. Multiple Member LLCs

Most LLCs with more than one member file a partnership return, Form 1065. A multi-member LLC that wants to file as a corporation must submit Form 8832. Form 8832 does not need to be submitted if the LLC wants to file as a partnership.

There is one significant limitation to the ability of a multi-member LLC to be treated as a partnership for tax purposes. Pursuant to I.R.S. Code § 7704, interests in the company cannot be publicly traded if the company wants to be treated as a partnership.

Table 8-2, below, summarizes the forms that a LLC is required to file depending on the number of members it has and the manner in which it elects to be taxed.

Table 8-2. Tax Forms Filed by Limited Liability Companies

TYPE OF ENTITY	FORM
Single-member LLC where member is an individual	1040
Single-member LLC where member is a corporation	1120 or 1120S
Multi-member LLC filing as partnership	1065
Multi-member LLC filing as corporation	8832 and 1120 or 1120S

C. EMPLOYMENT AND SELF-EMPLOYMENT TAXES

As we saw in the earlier discussion, employment tax requirements apply to LLCs in much the same way as other types of unincorporated businesses. Employees of all LLCs are subject to withholding taxes. Forms W-2 and Forms 1099 must be filed when required of all employers.

1. Self-Employment Taxes

Because LLC members are not employees but self-employed business owners, contributions to the Social Security and Medicare systems (collectively called the "self-employment" tax) are not withheld from their paychecks. Instead, most LLC owners are required to pay the self-employment tax directly to the IRS. With an S corporation, on the other hand, a shareholder pays the payroll tax on money received as compensation for services, but not on profits that automatically pass through as a shareholder.

The current rule is that any owner who works in or helps manage the business must pay this tax on his or her distributive share – i.e., his or her share of profits. However, owners who are not active in the LLC – that is, those who have merely invested money but do not provide services or make management decisions for the LLC – may be exempt from paying self-employment taxes on their share of profits.

Each owner who is subject to the self-employment tax reports it on Schedule SE, which is submitted annually with a 1040 tax return. LLC owners pay twice as much self-employment tax as regular employees, since regular employees' contributions to the self-employment tax are matched by their employers.

a. LLCs Filing Schedule C or E

Members are subject to self-employment taxes on earnings.

b. LLCs Filing Partnership Returns

Generally, members pay self-employment tax on their share of partnership earnings. There is a special rule for members who are the equivalent of limited partners. They pay self-employment tax only if the LLC pays them a "guaranteed payment" for services. As a member, an owner's liability for LLC debts are limited by state law. However, members, like shareholders of corporations, may be held personally liable in situations involving unpaid employee withholdings if the member in question is determined to be the person responsible for making the payments. Proposed IRS regulations would impose the self-employment tax on an LLC owner's entire share of LLC profits in any of the following situations:

- ☐ The owner participates in the business for more than 500 hours during the LLC's tax year;
- ☐ The LLC provides professional services in the fields of health, law, engineering, architecture, accounting, actuarial science or consulting (no matter how many hours the owner works); or
- ☐ The owner is empowered to sign contracts on behalf of the LLC.

Until the IRS clarifies the rules on self-employment tax for members of an LLC, members should assume that 100% of their earnings could be subject to self-employment tax.

D. TAXATION OF DISTRIBUTIONS

Each LLC member's share of profits and losses, called a distributive share, is set out in the LLC operating agreement.

Most operating agreements provide that a member's distributive share is in proportion to his percentage interest in the business. For instance, if Bill owns 70% of the LLC, and John owns the other 30%, Bill will be entitled to 70% of the LLC's profits and losses, and John will be entitled to the other 30%. If the members want to divide profits and losses in a manner that is not proportionate to the members' percentage interests in the business, it is called a "special allocation," and must comply with specific IRS rules.

Distributions to equity owners of businesses taxed as partnerships are normally not subject to income tax pursuant to IRC § 731, which provides, in part, that "gain shall not be recognized . . . except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution."

Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

Example.

The adjusted basis of Jo's partnership interest is \$14,000. She receives a distribution of \$8,000 cash and land that has an adjusted basis of \$2,000 and a fair market value of \$3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo's partnership interest to \$4,000 [$\$14,000 - (\$8,000 + \$2,000)$].

Likewise, I.R.C. §731 provides that a member of a limited liability company may not declare a loss "except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of: (A) any money distributed; and (B) the basis to the distributee."

In addition, passive activity limitations and at-risk rules that apply to partnerships generally may restrict the amount a member of a limited liability company may deduct.

The at risk rules of I.R.C. § 465 provide that the members are allowed to deduct their share of LLC losses to the extent they have an adequate amount at risk in the relevant activity. Generally, nonrecourse debt is not included in the amount at risk, but an exception exists for "qualified nonrecourse financing," which typically exists when a commercial lender makes a nonrecourse loan secured by real property.

Unlike a limited partnership in which the general partner is fully liable for partnership obligations, in an LLC no member may be liable for the LLC's obligations (except to the extent a member has separately agreed to assume them). Accordingly, even if the debt of an LLC is nominally recourse at the entity level, it may be nonrecourse to the members, thereby making it easier for LLC debt secured by real property to constitute "qualified nonrecourse financing."

For example, in a case of first impression, a federal district court in **Gregg v. U.S.**, 186 F.Supp.2d 1123 (2000), ruled that a member of a limited liability company was entitled to be treated like a general rather than a limited partner for purposes of determining whether he was an active participant in the business and therefore not subject to passive income limits.

E. RETAINED EARNINGS

The benefits of pass-through taxation available to most limited liability companies are obvious. However, there are certain circumstances under which an LLC might benefit from corporate tax status, depending on the nature of the business. One situation where this might be true is when a company has a large amount of retained earnings, that is when a company elects to keep a substantial amount of profits in the company rather than distributing it to its members.

Unlike an LLC, a corporation is responsible for paying taxes on corporate profits left or retained in the business. An LLC that elects corporate tax status, therefore, means that the company will pay tax on the earnings based on the income tax rates that apply to corporations. The members do not have to pay personal income taxes on those profits which are left in the company. And, because the corporate income tax rates for the first \$75,000 of corporate taxable income are lower than the individual income tax rates that apply to most LLC owners, this can save an individual and any co-owners money in overall taxes.

Example.

If an LLC needs to purchase expensive equipment at the beginning of each year, it may decide to leave \$50,000 in the business at the end of the year. With the regular pass-through taxation of an LLC, these retained profits would probably be taxed at the member's individual tax rate, which is probably over 25%. But with corporate taxation, that \$50,000 is taxed at the lower 15% corporate rate.

A limited liability company that elects corporate tax status by filing Form 8832 is precluded from switching back to partnership status for five years.

F. TAXATION OF A CONVERTED ENTITY

The conversion of a partnership into an LLC classified as a partnership for federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange or liquidation of any partnership interest, the partnership's tax year does not close, and the LLC can continue to use the partnership's taxpayer identification number.

However, the conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess. The same rules apply if an LLC classified as a partnership is converted into a partnership.

In ***Edwin E. McCauslen v. Commissioner***, 45 T.C. 588 (1966), one partner in an equal, two-person partnership died, and his partnership interest was purchased from his estate by the remaining partner. The purchase caused a termination of the partnership under § 708(b)(1)(A). The Tax Court held that the surviving partner did not purchase the deceased partner's interest in the partnership, but that the surviving partner purchased the partnership assets attributable to the interest. As a result, the surviving partner was not permitted to succeed to the partnership's holding period with respect to these assets.

Revenue Ruling 67-65, 1967-1 C.B. 168, also considered the purchase of a deceased partner's interest by the other partner in a two-person partnership. The Service ruled that, for the purpose of determining the purchaser's holding period in the assets attributable to the deceased partner's interest, the purchaser should treat the transaction as a purchase of the assets attributable to the interest. Accordingly, the purchaser was not permitted to succeed to the partnership's holding period with respect to these assets.

G. STATE TAXES AND FEES

The IRS's classification of an LLC as a partnership for tax purposes does not govern state law treatment. Most states that do impose a state income tax do, however, follow the federal lead and allow LLC's to elect pass-through tax status for state tax purposes.

Utah's law is indicative of that in most states. Section 59-10-801 provides that "for purposes of taxation under this title, a limited liability company or a foreign limited liability company transacting business in the state shall be classified in the same manner as it is classified for federal income tax purposes." Most states also do not distinguish between domestic and foreign limited liability companies for state tax purposes.

While an LLC might benefit from electing pass-through status for state tax purposes, or may even choose to operate in a state that does not impose an income tax, there could still be other costs associated with operating. For example, a number of states now impose an entity tax on LLCs as well as filing or registration fees which operate as a type of indirect tax.

California, for example, imposes an \$800 annual franchise fee on LLCs, while Massachusetts imposes a fee of \$500 per year. Florida, which does not have a state income tax, does impose its intangibles tax to membership interests in an LLC.

III. Partnerships

As we have already seen, a partnership is not a taxable entity. It files a return, but it is purely informational. A partnership computes its income and files its return in the same manner as an individual. However, certain deductions are not allowed to the partnership. This section will address basic rules in computing profit and loss.

Certain items must be separately stated on the partnership return and included as separate items on the partners' returns. These items, listed on Schedule K (Form 1065), are the following:

- ☐ Ordinary income or loss from trade or business activities;
- ☐ Net income or loss from rental real estate activities;
- ☐ Net income or loss from other rental activities;
- ☐ Gains and losses from sales or exchanges of capital assets;
- ☐ Gains and losses from sales or exchanges of property described in § 1231 of the Internal Revenue Code;
- ☐ Charitable contributions;
- ☐ Dividends (passed through to corporate partners) that qualify for the dividends-received deduction;
- ☐ Taxes paid or accrued to foreign countries and U.S. possessions; and
- ☐ Other items of income, gain, loss, deduction, or credit, as provided by regulations. Examples include nonbusiness expenses, intangible drilling and development costs, and soil and water conservation expenses.

A. ELECTIONS

The partnership makes most choices about how to figure income. These include choices for the following items:

- ☐ Accounting method;
- ☐ Depreciation method;
- ☐ Method of accounting for specific items, such as depletion or installment sales;
- ☐ Nonrecognition of gain on involuntary conversions of property; and
- ☐ Amortization of certain organization fees and business start-up costs of the partnership.

However, each partner chooses how to treat the partner's share of foreign and U.S. possessions taxes, certain mining exploration expenses, and income from cancellation of debt.

B. ORGANIZATION EXPENSES AND SYNDICATION FEES

Neither the partnership nor any partner can deduct, as a current expense, amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership.

The partnership can choose to amortize certain organization expenses over a period of not less than 180 months. The period must start with the month the partnership begins business. This election is irrevocable and the period the partnership chooses in this election cannot be changed. If the partnership elects to amortize these expenses and is liquidated before the end of the amortization period, the remaining balance in this account is deductible as a loss.

1. Making the Election

The election to amortize organization expenses is made by attaching a statement to the partnership's return for the tax year the partnership begins its business. The statement must provide all the following information:

- ☐ A description of each organization expense incurred (whether or not paid);
- ☐ The amount of each expense;
- ☐ The date each expense was incurred;
- ☐ The month the partnership began its business; and
- ☐ The number of months (not less than 180) over which the expenses are to be amortized.

Expenses less than \$10 need not be separately listed, provided the total amount is listed with the dates on which the first and last of the expenses were incurred. A cash basis partnership must also indicate the amount paid before the end of the year for each expense.

2. Amortizable Expenses

Amortization applies to expenses that are:

- ☐ Incident to the creation of the partnership;
- ☐ Chargeable to a capital account; and
- ☐ The type that would be amortized if they were incurred in the creation of a partnership having a fixed life.

To be considered incident to the creation of the partnership, an expense must be incurred during the period beginning at a point that is a reasonable time before the partnership begins business and ending with the date for filing the partnership return (not including extensions) for the tax year in which the partnership begins business. In addition, the expense must be for creating the partnership and not for starting or operating the partnership trade or business.

To be considered the type that would be amortized if incurred in the creation of a partnership having a fixed life, the expense must be for a type of item normally expected to benefit the partnership throughout its entire life. Organization expenses that can be amortized include the following:

- ❑ Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement;
- ❑ Accounting fees for services incident to the organization of the partnership; and
- ❑ Filing fees.

3. Expenses Not Amortizable

Expenses that cannot be amortized (regardless of how the partnership characterizes them) include expenses connected with the following actions:

- ❑ Acquiring assets for the partnership or transferring assets to the partnership;
- ❑ Admitting or removing partners other than at the time the partnership is first organized;
- ❑ Making a contract relating to the operation of the partnership trade or business (even if the contract is between the partnership and one of its members); and
- ❑ Syndicating the partnership. Syndication expenses, such as commissions, professional fees, and printing costs connected with the issuing and marketing of interests in the partnership, are capitalized. They can never be deducted by the partnership, even if the syndication is unsuccessful.

IV. Taxation of Corporations

The classic “knock” on corporate status is the onus of double taxation: the corporation pays federal income on its income at the entity level; the profits taken by shareholders – normally in the form of dividends – are then taxed to the individual. Shareholders who are also employees are allowed to receive a salary that is tax deductible to the corporation so long as it is not “excessive.” But that does not relieve the corporation of paying taxes on its profits.

A. INCOME TAX RETURN

Unless exempt under § 501 of the Internal Revenue Code, all domestic corporations in existence for any part of a taxable year (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

A corporation must generally file Form 1120 to report its income, gains, losses, deductions, credits, and to figure its income tax liability. However, a corporation may file Form 1120-A if its gross receipts, total income, and total assets are each under \$500,000 and it meets certain other requirements. Also, certain organizations must file special returns.

Generally, a corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

Form 7004 can be filed to request a 6-month extension of time to file a corporation income tax return. The IRS will grant the extension if the form is completed properly, filed, and any tax due is paid by the original due date for the return.

Form 7004 does not extend the time for paying the tax due on the return. Interest, and possibly penalties, will be charged on any part of the final tax due not shown as a balance due on Form 7004. The interest is figured from the original due date of the return to the date of payment.

A corporation that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. If the corporation is charged a penalty for late payment of tax for the same period of time, the penalty for late filing is reduced by the amount of the penalty for late payment. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or \$100. The penalty will not be imposed if the corporation can show the failure to file on time was due to a reasonable cause. Corporations that have a reasonable cause to file late must attach a statement explaining the reasonable cause.

A corporation that does not pay the tax when due may be penalized $\frac{1}{2}$ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the corporation can show that the failure to pay on time was due to a reasonable cause.

If income, social security, and Medicare taxes that a corporation must withhold from employee wages are not withheld or are not deposited or paid to the United States Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply if these unpaid taxes cannot be immediately collected from the business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying these taxes, and who acted willfully in not doing so.

A “responsible person” can be an officer or employee of a corporation, an accountant, or a volunteer director/trustee. A responsible person also may include one who signs checks for the corporation or otherwise has authority to cause the spending of business funds. “Willfully” means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows the required actions are not taking place.

B. INCOME AND DEDUCTIONS

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, some of the following special provisions apply only to corporations.

1. Below-Market Loans

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is considered as having received both the following:

- ❑ A loan in exchange for a note that requires payment of interest at the applicable federal rate, and
- ❑ An additional payment.

2. Capital Losses

A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. Instead, it carries the loss to other tax years and deducts it from capital gains that occur in those years.

First, the corporation can carry a net capital loss back three years. It is deducted from any total net capital gain that occurred in that year. If the corporation does not deduct the full loss, it can carry it forward one year (two years back) and then one more year (one-year back). If any loss remains, it can carry it over to future tax years, one year at a time, for up to five years. When a net capital loss is carried to another tax year, it is treated as a short-term loss. It does not retain its original identity as long term or short term.

Example.

In 2008, a calendar year corporation has a net short-term capital gain of \$3,000 and a net long-term capital loss of \$9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of \$6,000. The corporation treats this \$6,000 as a short-term loss when carried back or forward.

The corporation carries the \$6,000 short-term loss back 3 years to 2005. In 2005, the corporation had a net short-term capital gain of \$8,000 and a net long-term capital gain of \$5,000. It subtracts the \$6,000 short-term loss first from the net short-term gain. This results in a net capital gain for 2005 of \$7,000. This consists of a net short-term capital gain of \$2,000 (\$8,000 - \$6,000) and a net long-term capital gain of \$5,000.

3. S Corporation Status

A corporation may not carry a capital loss from, or to, a year for which it is an S corporation.

4. Rules for Carryover and Carryback

When carrying a capital loss from one year to another, the following rules apply:

- ❑ When figuring the current year's net capital loss, a corporation cannot combine it with a capital loss carried from another year. In other words, it can carry capital losses only to years that would otherwise have a total net capital gain;
- ❑ If a corporation carries capital losses from two or more years to the same year, they deduct the loss from the earliest year first; and
- ❑ A corporation cannot use a capital loss carried from another year to produce or increase a net operating loss in the year to which it carries it back.

5. Charitable Contributions

A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization.

A corporation may not take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

a. Cash method corporation. A corporation using the cash method of accounting deducts contributions in the tax year paid.

b. Accrual method corporation. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them within 2½ months after the close of that tax year. The corporation makes the choice by reporting the contribution on the corporation's return for the tax year. A copy of the resolution authorizing the contribution and a declaration stating that the board of directors adopted the resolution during the tax year must accompany the return. An officer authorized to sign the return must sign the declaration under penalties of perjury.

c. Limit. A corporation cannot deduct charitable contributions that exceed 10% of its taxable income for the tax year. Taxable income is figured for this purpose without the following:

- ❑ The deduction for charitable contributions;
- ❑ The deduction for dividends received;
- ❑ Any net operating loss carry-back to the tax year; and
- ❑ Any capital loss carry-back to the tax year.

d. Carryover of excess contributions. A corporation may carry over, within certain limits, to each of the subsequent five years any charitable contributions made during the current year that exceed the 10% limit. A corporation may lose any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 2006 and it does not use all the excess on its return for 2007, it can carry the rest over to 2008, 2009, 2010, and 2011. A corporation does not deduct a carryover of excess contributions in the carryover year until after they deduct contributions made in that year (subject to the 10% limit). The corporations cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover.

6. Corporate Preference Items

A corporation must make special adjustments to certain items before it takes them into account in determining its taxable income. These items are known as corporate preference items. For more information on corporate preference items, see § 291 of the Internal Revenue Code.

7. Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year. This section discusses the general rules that apply.

a. Dividends from domestic corporations. A corporation can deduct, within certain limits, 70% of the dividends received if the corporation receiving the dividend owns less than 20% of the corporation distributing the dividend. If the corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 80% of the dividends received.

b. Ownership. Determine ownership, for these rules, by the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) the receiving corporation owns.

c. Small business investment companies. Small business investment companies can deduct 100% of the dividends received from taxable domestic corporations.

d. Dividends from regulated investment companies. Regulated investment company dividends received are subject to certain limits. Capital gain dividends received from a regulated investment company do not qualify for the deduction. For more information, see section 854 of the Internal Revenue Code.

e. No deduction allowed for certain dividends. Corporations cannot take a deduction for dividends received from the following entities:

- ☐ A real estate investment trust (REIT);
- ☐ A corporation exempt from tax under section 501 or 521 of the Internal Revenue Code either for the tax year of the distribution or the preceding tax year;

- ❑ A corporation whose stock was held less than 46 days during the 90-day period beginning 45 days before the stock became ex-dividend with respect to the dividend. Ex-dividend means the holder has no rights to the dividend;
- ❑ A corporation whose preferred stock was held less than 91 days during the 180-day period beginning 90 days before the stock became ex-dividend with respect to the dividend if the dividends received are for a period or periods totaling more than 366 days; and
- ❑ Any corporation, if the corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest, not dividends. They do not qualify for this deduction.

The total deduction for dividends received or accrued is generally limited (in the following order) to:

- ❑ 80% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations, then
- ❑ 70% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

In figuring the limit, determine taxable income without the following items:

- ❑ The net operating loss deduction;
- ❑ The deduction for dividends received;
- ❑ Any adjustment due to the nontaxable part of an extraordinary dividend; and
- ❑ Any capital loss carryback to the tax year.

If a corporation has a net operating loss (NOL) for a tax year, the limit of 80% (or 70%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 80% (or 70%) of taxable income limit.

Example 1.

A corporation loses \$25,000 from operations. It receives \$100,000 in dividends from a 20%-owned corporation. Its taxable income is \$75,000 (\$100,000 - \$25,000) before the deduction for dividends received. If it claims the full dividends-received deduction of \$80,000 (\$100,000 × 80%) and combines it with an operations loss of \$25,000, it will have an NOL of (\$5,000). Therefore, the 80% of taxable income limit does not apply. The corporation can deduct the full \$80,000.

Example 2.

Assume the same facts as in Example 1, except that the corporation only loses \$15,000 from operations. Its taxable income is \$85,000 before the deduction for dividends received. After claiming the dividends-received deduction of \$80,000 (\$100,000 × 80%), its taxable income is \$5,000. Because the corporation will not have an NOL after applying a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or \$68,000 (\$85,000 × 80%).

8. Extraordinary Dividends

If a corporation receives an extraordinary dividend on stock held two years or less before the dividend announcement date, it generally must reduce its basis in the stock by the nontaxed part of the dividend. The nontaxed part is any dividends-received deduction allowable for the dividends. An extraordinary dividend is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock. The percentages are 5% for stock preferred as to dividends or 10% for other stock.

Corporations should treat all dividends received that have ex-dividend dates within an 85-consecutive-day period as one dividend. Corporations should treat all dividends received that have ex-dividend dates within a 365-consecutive-day period as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock.

Any dividend on disqualified preferred stock is treated as an extraordinary dividend regardless of the period of time the corporation held the stock. Disqualified preferred stock is any stock preferred as to dividends if any of the following apply.

- ❑ The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future;
- ❑ The issue price of the stock exceeds its liquidation rights or stated redemption price; or
- ❑ The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

These rules apply to stock issued after July 10, 1989, unless it was issued under a written binding contract in effect on that date, and thereafter, before the issuance of the stock.

C. GOING INTO BUSINESS

When going into business, certain costs incurred to get the business started are treated as capital expenses. A corporation can choose to amortize certain costs over a period of 60 months or more. To qualify, the cost must be one of the following: (1) a business start-up cost, or (2) an organizational cost.

1. Business Start-up Costs

Start-up costs are costs incurred for creating an active trade or business or for investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with an activity engaged in for profit or for the production of income in anticipation of the activity becoming an active trade or business. A start-up cost is amortizable if it meets both of the following tests;

- ❑ It is a cost you could deduct if you paid or incurred it to operate an existing active trade or business (in the same field); and
- ❑ It is a cost you pay or incur before the date your active trade or business begins.

Start-up costs include costs for the following:

- ❑ An analysis or survey of potential markets, products, labor supply, transportation facilities, etc.;
- ❑ Advertisements for the opening of the business;
- ❑ Salaries and wages for employees who are being trained, and their instructors;
- ❑ Travel and other necessary costs for securing prospective distributors, suppliers, or customers; and
- ❑ Salaries and fees for executives and consultants, or for similar professional services.

Start-up costs do not include deductible interest, taxes, or research and experimental costs.

2. Purchasing an Active Trade or Business

Amortizable start-up costs for purchasing an active trade or business include only investigative costs incurred in the course of a general search for, or preliminary investigation of, the business. Investigative costs are costs that help you decide whether to purchase any business and which business to purchase. Alternatively, costs you incur in an attempt to purchase a specific business are capital expenses and you cannot amortize them.

If you completely dispose of your business before the end of the amortization period, you can deduct any remaining deferred start-up costs to the extent allowable under § 165 of the Internal Revenue Code.

3. Organizational Costs

The costs of organizing a corporation are the direct costs of creating the corporation. Organizational costs may be amortized only if they meet all of the following tests:

- ❑ They are for the creation of the corporation;
- ❑ They are chargeable to a capital account;
- ❑ They can be amortized over the life of the corporation, if the corporation had a fixed life; and
- ❑ They are incurred before the end of the first tax year in which the corporation is in business. A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.

The following are examples of organizational costs:

- ❑ The cost of temporary directors;
- ❑ The cost of organizational meetings;
- ❑ State incorporation fees;
- ❑ The cost of accounting services for setting up the corporation; and
- ❑ The cost of legal services (such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings).

The following costs are not organizational costs. They are capital expenses that cannot be amortized:

- ❑ Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs; and
- ❑ Costs associated with the transfer of assets to the corporation.

4. Related Persons

A corporation that uses an accrual method of accounting cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting until the corporation makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if the corporation's relationship with the person ends before the expense or interest is

includible in the gross income of that person. These rules also deny the deduction of losses on the sale or exchange of property between related persons.

For purposes of this rule, the following persons are related to a corporation:

- ❑ Another corporation that is a member of the same controlled group as defined in § 267(f) of the Internal Revenue Code;
- ❑ An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation;
- ❑ A trust fiduciary when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation;
- ❑ An S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation;
- ❑ A partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership; and
- ❑ Any employee-owner if the corporation is a personal service corporation (defined later), regardless of the amount of stock owned by the employee-owner.

To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply:

- (1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries;
- (2) An individual is treated as owning the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters (including half brothers and half sisters), a spouse, ancestors, and lineal descendants; and
- (3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner.

To apply rule (1), (2), or (3), stock constructively owned by a person under rule (1) is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) or (3) is not treated as actually owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

5. Personal Service Corporation

For this purpose, a corporation is a personal service corporation if it meets all of the following requirements:

- (1) It is not an S corporation;

- (2) Its principal activity is performing personal services. Personal services are those performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and performing arts;
- (3) Its employee-owners substantially perform the services in (2); and
- (4) Its employee-owners own more than 10% of the fair market value of its outstanding stock.

Where it is necessary to clearly show income or prevent tax evasion, the IRS can reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly, or indirectly, by the same interests. The disallowance of losses from the sale or exchange of property between related persons does not apply to liquidating distributions.

6. U.S. Real Property Interest

If a domestic corporation acquires a U.S. real property interest from a foreign person or firm, the corporation may have to withhold tax on the amount it pays for the property. The amount paid includes cash, the fair market value of other property, and any assumed liability. If a domestic corporation distributes a U.S. real property interest to a foreign person or firm, it may have to withhold tax on the fair market value of the property. A corporation that fails to withhold may be liable for the tax, and any penalties and interest that apply.

V. Subchapter S Corporations

The essence of a subchapter S corporation is that its owners have the limited liability offered by a corporation and the pass-through taxation of a partnership or limited liability company. This can be particularly useful for closely-held corporations that expect to suffer a loss, particularly at the beginning of the business. Subchapter S status allows the loss to be passed through directly to the shareholder. This loss can be offset against gains from other activities, subject to the limitations of the passive-income and at-risk rules.

Some of the factors to consider when making a choice of entity that includes S corporation status include:

- ❑ The IRS treats a subchapter S corporation like a partnership for income tax purposes, but as a corporation for determining the tax treatment on dissolution;
- ❑ There are significant limits on who, and how many people, can have an ownership interest in an S corporation; and
- ❑ Failure to meet the strict statutory requirements for S corporation status can result in a retroactive loss of status and additional tax liabilities.

To be eligible for S corporation status, the corporation must first be duly organized under the laws of its state of organization. S corporation status must then be affirmatively elected by *all* shareholders. This election is made using Form 2553 and must be filed within the first two and one-half months of the taxable year of the corporation or at any time prior to that, but not more than one year. A late election is considered valid for the following year.

Once elected, income and deductions pass through to the shareholder in the same fashion as a partnership. However, special allocations available to a partnership (as discussed above) are not available to S corporations. This also holds true for losses, except that they are limited by the shareholders' basis in corporate stock. This is similar to partnership losses, as discussed above. Likewise, capital gains pass through.

Subchapter S status may be terminated either voluntarily – through a vote of the shareholders – or involuntarily. Involuntary termination occurs whenever any of the preconditions for electing the status fail to exist any longer, i.e. when the maximum number of shareholders is exceeded or when a second class of stock is created or stock passes into the hands of an unqualified shareholder.

The holders of more than 50% of the stock may terminate the election voluntarily. No special form is required. Once an election has been terminated, the corporation may not again elect for the next four years, except under certain circumstances with the consent of the IRS.

A. RIGHT TO OFFSET OTHER INCOME

Because subchapter S corporation income and loss items pass through to the shareholders, losses can offset income generated from other activities by shareholders. The losses the subchapter S corporation generates may offset income generated by other activities, provided the shareholder's basis in his or her stock is sufficient to permit the deduction of the loss.

B. TAX ON EXCESSIVE PASSIVE INVESTMENT INCOME

The tax on excessive passive investment income also applies only to subchapter S corporations that had a prior existence as subchapter C corporations. Excessive passive investment income may terminate the subchapter S election, but even if the IRS waives termination, this excess income will give rise to a corporate level tax at the normal corporate tax rate.

CHAPTER 8 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following is a tax advantage of organizing a business as a partnership:
 - a) partners do not have to pay self-employment tax
 - b) there is no double taxation
 - c) they are allowed to choose their tax treatment
 - d) the tax rate is lower than for other types of entities
2. Why do people in business try to organize in such a way as to reduce or eliminate their liability for self-employment tax:
 - a) people subject to this tax are much more likely to be audited
 - b) it is a very expensive tax with a rate of 15.3%
 - c) it is complex to administer
 - d) all of the above
3. A single-member LLC is required to file Form 1040 if the member is an individual.
 - a) true
 - b) false
4. Which of the following statements about distributions to members of an LLC is correct:
 - a) each owner's share of earnings is usually determined by the LLC's operating agreement
 - b) for entities treated as partners, the earnings are passed through to the owner before being taxed
 - c) in most cases, an owner's share of the profits is proportional to their investment in the company
 - d) all of the above
5. Among the expenses that can be amortized by a partnership are the expenses incurred in acquiring assets for the partnership.
 - a) true
 - b) false

6. All of the rules that apply to individuals regarding income and deductions also apply to corporations.
- a) true
 - b) false
7. Which of the following statements best describes the essence of a subchapter S corporation:
- a) the shareholders do not enjoy the limited liability of a C corporation but avoid tax on corporate income
 - b) the shareholders are taxed in the same manner as shareholders of a C corporation
 - c) the shareholders enjoy limited liability and are taxed in the same manner as a partnership
 - d) they are intended for entities with a large number of shareholders

CHAPTER 8 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. There is no categorical exclusion from self-employment tax for partners.

B: Correct. Income of the business is passed through to the partners directly rather than first being taxed at the entity level as with corporations.

C: Incorrect. This is a characteristic of limited liability companies and not of partnerships.

D: Incorrect. The tax rate is not lower based on the business's status as a partnership.

(See page 8-1 of the course material.)

2. A: Incorrect. There is no such correlation.

B: Correct. This expensive tax consists of 12.4% for social security and 2.9% for Medicare.

C: Incorrect. The sole reason to avoid this tax is cost.

D: Incorrect. Only one of the responses is correct.

(See page 8-2 of the course material.)

3. **A: True is correct.** In this situation, the LLC is treated as a sole proprietorship, and the entity is not considered separate from the LLC. The return he or she files is the same as an individual.

B: False is incorrect. A single-member LLC where the member is a corporation must file Form 1120 or Form 1120S.

(See page 8-6 of the course material.)

4. A: Incorrect. The operating agreement sets forth most of the rules governing an LLC, including the manner in which profits are distributed. However, this is not the most correct answer.

B: Incorrect. This sort of pass through taxation occurs when the LLC has elected to be taxed as a partnership. However, this is not the correct answer.

C: Incorrect. This means that if someone invested 80% of the capital, they would typically receive 80% of the profits. However, this is not the best answer.

D: Correct. All of the responses are correct.

(See page 8-8 of the course material.)

5. A: True is incorrect. The organization expenses that can be amortized include legal and accounting fees for services incident to the organization of the partnership and filing fees.

B: False is correct. Other expenses that cannot be amortized as organizational expenses are the costs associated with admitting or removing partners other than at the time the partnership is first organized, making a contract relating to the operation of the partnership trade or business, and syndication expenses.

(See page 8-13 of the course material.)

6. A: True is incorrect. There are a few special provisions that only apply to corporations.

B: False is correct. Special provisions that only apply to corporations (and not individuals) include below-market loans, capital losses, S corporation status, rules for carryover and carry-back of capital losses, and charitable contributions.

(See pages 8-15 to 8-19 of the course material.)

7. A: Incorrect. Shareholders of a subchapter S corporation do enjoy limited liability and are subject to taxation in the same manner as a partnership.

B: Incorrect. One of the hallmarks of the subchapter S corporation is pass-through taxation similar to partnerships.

C: Correct. These are the two keys of subchapter S corporations. S corporations are also generally closely-held, as there are limits on who can be shareholders and how many shareholders there can be.

D: Incorrect. To the contrary, there is a cap on the number of shareholders allowed.

(See page 8-23 of the course material.)

Chapter 9: Alternative Minimum Tax

I. Alternative Minimum Tax

A. OVERVIEW AND HISTORY OF AMT

The Alternative Minimum Tax (AMT) is a parallel income tax originally designed to ensure that taxpayers with substantial economic income pay at least some minimum level of tax. However, the AMT was never intended to reach middle-income taxpayers nor to become the tax system applicable to most taxpayers.

To calculate the AMT, taxpayers first determine tax liability under the regular income tax, and then add back certain “preference” items to taxable income. After deducting an exemption amount under AMT, taxpayers pay whichever is higher under the regular income tax or AMT. Personal exemptions, the itemized deductions for state and local taxes, and miscellaneous itemized deductions together account for 90% of the preference items added back under the AMT, with state and local taxes almost half of that amount.

There are two main reasons for the increase in the number of taxpayers affected by the AMT. First, the tax cuts under the regular income tax that were enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the Working Families Tax Relief Act of 2004 have narrowed significantly the differences between regular and AMT tax liabilities for middle and higher income individuals. Second, regular income tax brackets are indexed for inflation, but the AMT thresholds are not. This has, over time, reduced further the differences between regular income tax liabilities and AMT liabilities at lower income levels.

The combination of the two factors stated above means that, absent Congressional action on the issue, the number of taxpayers that will be affected by the AMT will grow significantly. The number of taxpayers subject to the AMT is expected to jump considerably without legislative reform. By 2015, 51.3 million taxpayers will be affected by the AMT, roughly 45% of all taxpayers with income tax liability. This is up from 20.5 million taxpayers in 2006. The revenue raised by the AMT is also expected to increase over the coming years from \$15 billion in 2004 to \$210 billion by 2015 (11% of total individual income tax revenues). The primary reason the AMT grows more rapidly over time than regular income tax is that the regular tax is generally indexed for inflation, but the AMT is not.

B. CURRENT YEARS' AMT

Internal Revenue Code §§ 55, 56, 57, 58, and 59 contain the current laws surrounding this computation. AMT is calculated by adjusting the taxpayer's regular taxable income with a number of tax preference items and adjustments. Tax preference items are positive items increasing Alternative Minimum Taxable Income (AMTI) and are excluded from regular taxable income. Tax preference items include tax-exempt interest from certain private activity bonds, depletion, intangible drilling costs, accelerated depreciation on leased personal or real property placed in service before 1987, amortization of certain pollution control costs or facilities placed in service before 1987, and certain leased property subject to accelerated cost recovery.

Adjustments for AMT may result in positive and negative amounts and may have implications in subsequent tax years. Adjustments include standard or itemized deductions, personal exemptions, 1987 and subsequent-year depreciation based on the alternative depreciation system, amortization of circulation and research and experimental costs, amortization of mining exploration and development costs, amortization of pollution control costs for facilities placed in service after 1986, use of percentage completion for long-term contracts entered into after February 28, 1986, installment sale adjustments, gain or loss adjustments on the disposition of business property, incentive stock options, tax shelter farm loss limitations, passive activity loss limitations, and AMT net operating loss.

II. Other Provisions That Affect AMT

A. KIDDIE TAX

Congress was concerned that some higher income individuals may have been transferring earnings to their children so that the earnings would be taxed at a lower rate. The TRA of 1986 offered a remedy to this potential inequity. The rules regarding the age of a child whose investment income may be taxed at the parent's tax rate changed in 2008. These rules will continue to apply to a child under age 18 at the end of the year but, as of January 1, 2008, will also apply to a child who is age 18 at the end of the year, or a student under age 24 at the end of the year, whose earned income is not more than half of the child's support.

The unearned income of a minor for taxable years beginning in 2009, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is \$950. This amount is the same as the \$950 standard deduction amount provided in section 3.10(2) of Revenue Procedure 2008-66.

The same \$950 amount is used for purposes of § 1(g)(7) (that is, to determine whether a parent may elect to include a child's gross income in the parent's gross income and to calculate the "kiddie tax"). For example, one of the requirements for the parental election is that a child's gross income is more than the amount referenced in § 1(g)(4)(A)(ii)(I) but less than 10 times that amount; thus, a child's gross income for 2009 must be more than \$950 but less than \$9,500.

For taxable years beginning in 2009, for a child to whom the § 1(g) "kiddie tax" applies, the exemption amount under §§ 55 and 59(j) for purposes of the alternative minimum tax under § 55 may not exceed the sum of (1) the child's earned income for the taxable year, plus (2) \$6,700.

DID YOU KNOW?

- The minimum tax was enacted into law in 1969 after Congress learned that 155 taxpayers with adjusted gross incomes (AGI) of \$200,000 or more for the 1966 tax year had paid no federal tax at all;
- The Joint Committee on Taxation projects that within the next decade, almost two million taxpayers with incomes as low as \$30,000 will have to prepare the AMT schedule with their tax returns – if only to prove that they do not owe AMT;
- In tax year 2001, over 660,000 taxpayers with adjusted gross incomes under \$200,000 paid more than \$1.625 billion in AMT. The number of taxpayers with AGI of less than \$50,000 owing AMT in 2001 is virtually the same as the number of taxpayers with AGI between \$475,000 and \$500,000 who owe no AMT;
- In 2010, the AMT is projected to affect nearly 32 million taxpayers. The majority will have incomes under \$100,000, and more than 36 percent of taxpayers with incomes between \$50,000 and \$75,000 will owe AMT;
- Taxpayers must fill out a 12-line worksheet, read eight pages of instructions, and complete a 65-line form – only to find they owe little or no AMT after all. Other taxpayers must complete the 65-line form, even though they are not subject to the AMT, to substantiate their entitlement to certain tax credits;
- Taxpayers subject to the AMT must calculate their tax liability twice, once under regular income tax rules and again under AMT rules; and
- Taxpayers are projected to lose the benefit of nearly 12 billion dollars in tax credits (such as business credits) in 2010 because of AMT.

IRC § 59(j) was enacted for tax years beginning after 1988. The Form 6251 worksheet (Limit on Alternative Minimum Tax for Children Under the Age of 18) can be used to calculate the AMT kiddie tax for a child. The first step, in computing the AMT kiddie tax, is to compute the child's AMT in the usual manner except that the AMT exemption is equal to earned income plus the exemption amount under IRC § 59(j)(1).

1. Rate Capped

For tax years beginning after December 31, 1997, IRC § 59(j)(i) provides that the IRC § 55 exemption amount for children subject to IRC § 1(g) is capped at the child's earned income plus \$5,000 adjusted for inflation. The cap for 2008, for example, was \$6,400.

2. Limits on Standard Deduction

For 2008, the limit on the standard deduction is the greater of \$900 or earned income plus \$300 (IRC §63(c)(5)(B)).

B. PARTNERSHIP AND S CORPORATION FLOW-THROUGHS

AMT pass-through items are required to be reported on each shareholder's or partner's tax return. The allocation for these items should follow the regular tax allocation rules.

Example.

An S corporation is made up of two individuals, Sally and George, each 50-percent shareholders. Each shareholder would report 50-percent of the income or loss (disregarding the basis, passive and at-risk rules) on their individual returns. If the S corporation has AMT tax preference items or adjustments, these will be computed at the S corporation level and divided by percentage of ownership between the shareholders. If the S corporation had a regular depreciation of \$2,000 and AMT depreciation of \$1,000, of the \$1,000 AMT adjustment, \$500 would be allocable to each 50-percent partner. This figure is then reported on the depreciation adjustment line of Form 6251 and is added with the shareholder's other AMT adjustment and preference items.

C. AT-RISK RULES AND BASIS LIMITATIONS

Per IRC § 59(h), the at-risk rules of IRC § 465 and basis limitation rules of IRC § 704(d) and IRC § 1366(d) require a separate computation of allowable deductions.

Example.

Wendy has a property for which she is at risk for \$1,000. For regular tax purposes, if her deductions exceed the \$1,000 she will not be allowed to take these amounts and will have a suspended loss. If, however, for AMT purposes the deductions are less than \$1,000 then she will have unused at-risk for AMT purposes.

It is therefore important to keep separate records regarding the at-risk amount (as well as any basis limitations) for regular tax purposes and for AMT purposes.

D. ESTIMATED TAX PAYMENTS

For purposes of making estimated tax payments per IRC § 6654, the taxpayer's AMT liability must be considered and included in the taxpayer's computations regarding estimated payments.

E. SHORT TAX YEARS

AMT computed for a short taxable year requires a taxpayer to annualize AMT taxable income (multiply by 12 and divide by number of months in the short year). Then multiply the resulting tentative AMT by a fraction which is the number of months in the short year divided by 12.

III. Minimum Tax Credit

A. MINIMUM TAX CREDIT/GENERAL RULES

The Minimum Tax Credit (MTC) is the difference between the AMT computed "with exclusion and deferral items" in the usual manner and the AMT computed using only exclusion items or "without deferral preferences." The MTC is carried forward (no carrybacks are allowed) to the next year and can reduce only the excess of the regular tax (reduced by all other nonrefundable credits) over the tentative minimum tax in a subsequent year. If all of the credit is not used in the subsequent year, it is aggregated in future years and becomes part of the MTC for that year. This credit is carried forward indefinitely until used in full.

The MTC is computed only on deferral items. IRC § 53(d)(1)(B)(ii) lists the "exclusion" amounts which are not allowed in the computation of MTC. These exclusion items include adjustment for miscellaneous itemized deductions and certain taxes (IRC § 56(b)(1)), depletion preference (IRC § 57(a)(1)), tax-exempt interest on private activity bonds (IRC § 57(a)(5)), and the exclusion for gains on sale of certain small business stock (IRC § 57(a)(7)). All other AMT adjustments and preference items are deferral items and are included in the computation of the MTC.

Example 1.

Don and Tanya file a married filing joint return for 2007. They have taxable income of \$80,000 and a regular tax liability of \$17,610. They have deferral items of \$45,000 and exclusion items of \$20,000. The MTC carryforward to 2008 is computed as follows:

AMT with both deferral items and exclusion items.

Taxable Income	\$ 80,000
Deferral Items	\$ 45,000
Exclusion Items	\$ 20,000
Exemptions	(\$ 45,000)

	\$100,000 @ 26%

Tentative AMT	\$ 26,000
Regular Tax	<u>(\$17,610)</u>
Net Minimum Tax	<u>\$ 8,390</u>

AMT with only exclusion items or "without deferral items"

Taxable Income	\$80,000
Exclusion Items	\$20,000
Exemption	(\$45,000)
	<hr/>
	\$55,000 @ 26%
	<hr/>
Tentative AMT	\$14,300
Regular Tax	(\$17,610)
	<hr/>
Net Minimum Tax	<u>\$ -0-</u>

MTC is to be carried over to 2008 is \$8,390. The amount of this credit to be used in 2008 is limited to the amount that the taxpayers' regular tax exceeds their tentative minimum tax for 2008.

Example 2.

Assume that in 2008 Don and Tanya have a regular tax liability of \$25,000 and a minimum tax of \$20,000. The amount of MTC available for Don and Tanya for 2008 is \$5,000, (the difference between the regular tax liability of \$25,000 and the tentative minimum tax of \$20,000). The remaining \$3,390 (\$20,000 - \$17,610) is carried forward and used in future tax years.

In certain circumstances, such as the sale of depreciable property or assets nearing the end of their depreciable life (where the straight-line AMT adjustment exceeds the accelerated method), a negative MTC adjustment may result. The following example illustrates this point.

Example.

Jim and Marsie file a joint tax return for 2008. Their regular taxable income is \$90,000. They had deferral items (depreciation) of (\$10,000) and exclusion items of \$50,000.

AMT with both exclusion and deferral items

Regular Taxable Income	\$ 90,000
AMT Deferral Items	(\$ 10,000)
AMT Exclusion Items	\$ 50,000
	<hr/>
AMTI with deferrals and exclusions	\$130,000
Exemption	(\$ 45,000)
	<hr/>
	\$85,000 @ 26%
	<hr/>
Tentative Minimum Tax	\$ 22,100
Regular Tax	(\$ 20,436)
	<hr/>
AMT	<u>\$ 1,664</u>
	=====

AMT using exclusion items only or "without deferral items"

Regular Taxable Income	\$ 90,000
AMT Exclusion Items	\$ 50,000

AMTI with exclusion items	\$140,000
Exemption	(\$ 45,000)

	\$95,000 @ 26%

Tentative Minimum Tax	\$ 24,700
Regular Tax	(\$ 20,436)

AMT	\$ 4,264
	=====

Difference between AMT with exclusions and deferrals \$1,664 and AMT with exclusion items only \$4,264 is (\$2,600). This negative amount will offset prior positive credits generated in the earlier years of the asset's life when the accelerated depreciation exceeds the AMT depreciation.

This computation shows once again the importance of the taxpayer keeping separate books for regular and AMT purposes.

B. MINIMUM TAX CREDIT NET OPERATING LOSS (MTCNOL)

When computing the NOL for MTC purposes (known as MTCNOL), the NOL for the exclusion items only or without deferral items should be computed using only the exclusion items. IRC § 53(d)(1)(B)(i)(II) further states that this amount will not be subject to the ninety percent limitation of tax per IRC § 59(a)(2) (relating to foreign tax credit). If a taxpayer used a carryback of an AMTNOL to reduce a prior year's AMT liability and the prior year's AMT liability generated a MTC which was carried forward and used, the taxpayer will have to recapture the MTC in the year in which it was used.

C. MINIMUM TAX CREDIT AND AMT FOREIGN TAX CREDIT

As previously discussed under the MTCNOL, the 90-percent limitation of taxable income does not exist when computing the FTC for AMT with exclusion items only.

Example.

If tentative income tax before credits for both AMT with deferrals and exclusions and AMT with exclusions only is \$34,000, and the FTC is \$40,000, the FTC allowed for AMT with deferrals and exclusions would be limited to 90 percent or \$30,600. When computing the FTC for AMT with exclusions only, the 90-percent limitation does not apply. Thus, the full \$34,000 can be offset by the FTC. In this example, there would be an MTC of \$3,400.

D. SPECIAL RULES

In the limited circumstances when a taxpayer has a nonconventional fuel credit under IRC § 29, special MTC provisions can apply. For regular tax purposes, such fuel credit is usually limited to the excess of a taxpayer's regular tax over the tentative minimum tax. If this regular tax limitation causes a taxpayer to lose the benefit of a portion of the fuel credit, the taxpayer is allowed to increase the MTC by the disallowed credit amount. IRC section 53(d)(1)(B)(iii).

For example, a taxpayer who cannot use \$5,000 of his non-conventional fuel credit due to the IRC § 29(b)(6)(B) limitation can increase his or her MTC by \$5,000. A similar rule for the non-conventional fuel credit is provided for the orphan drug credit and the qualified electric vehicle credit.

E. COMPUTING THE MINIMUM TAX CREDIT

The computation of the MTC is completed by taxpayers on Form 8801, Credit for Prior Year Minimum Tax-Individuals, Estates, and Trusts. Form 8801 should be filed for each year that a taxpayer had a MTC carryover.

IV. How the AMT Is Calculated

The AMT is a separate system from the regular income tax, with unique rules governing the recognition of income and the timing of deductions and credits. Taxpayers are often required to maintain two sets of records – one for regular income tax purposes and one for AMT purposes.

The determination of AMT liability, if any, is complex:

- ❑ First, the taxpayer must calculate his or her regular tax liability. The regular income tax rules provide preferred treatment for certain types of income and allow taxpayers to claim certain exemptions, deductions, exclusions and credits;
- ❑ Second, the taxpayer must determine whether he or she is subject to additional tax under the AMT regime. The IRS has developed a 12-line worksheet (Worksheet To See If You Should Fill in Form 6251) to help taxpayers determine whether they may be subject to the AMT. If the worksheet indicates that a taxpayer is potentially subject to the AMT, the taxpayer must complete Form 6251 (Alternative Minimum Tax – Individuals), which contains 55 lines. Many taxpayers are required to complete Form 6251 – only to find that they do not have an AMT liability;
- ❑ Third, the taxpayer must compute their alternative minimum taxable income (AMTI) on Form 6251. This computation generally requires taxpayers to give up the benefit of tax preference items to which they are entitled under the regular tax system (e.g., dependence exemptions, a standard deduction, and itemized deductions for state and local taxes, employee business expenses and legal fees);

- ❑ Fourth, the taxpayer must determine an “exemption amount” to which he is entitled based on filing status;
- ❑ Fifth, the taxpayer must compute his “taxable excess” by subtracting his exemption amount from his AMTI;
- ❑ Sixth, a taxpayer with a positive “taxable excess” must compute his “tentative minimum tax.” A “taxable excess” of \$175,000 or less is taxed at a 26 percent rate and any additional “taxable excess” is taxed at a 28 percent rate. (The total amount is the tentative minimum tax);
- ❑ Seventh, the taxpayer must compute his “alternative minimum tax” or “AMT.” The AMT is equal to the excess of the taxpayer’s tentative minimum tax, if any, over his regular tax liability (reduced by any tax from Form 4972 (Tax on Lump Sum Distributions) and any foreign tax credit from Form 1040). If the net result is a negative number or zero, the taxpayer does not owe AMT.
- ❑ Eighth, if the taxpayer owes AMT, he computes his final tax liability by adding his regular tax liability and his AMT liability.

The “exemption amount” described above replaces the standard deduction and personal exemptions for purposes of computing the AMT. Congress increased the exemption amounts in 2008 to \$69,950 for married individuals filing jointly and \$46,200 for most other taxpayers. The exemption amount is phased out for married taxpayers with AMTI exceeding \$150,000 and non-married taxpayers with AMTI exceeding \$112,500.

A taxpayer who is subject to the AMT accrues AMT credits. However, these credits may be applied only to timing items – not to exclusion items. Timing items are those that are accounted for in different tax years in the regular tax and AMT systems. For example, the AMT in some instances requires taxpayers to depreciate property over a longer period of time. Exclusion items are adjustments and tax preference items that result in the permanent disallowance of certain tax benefits such as the standard deduction, personal exemptions and certain itemized deductions. In addition, AMT credits can only be used when the regular tax liability reduced by other non-refundable credits exceeds the tentative minimum tax for the tax year.

To claim AMT credits, taxpayers must complete Form 8801 (Credit For Prior Year Minimum Tax – Individuals, Estates, and Trusts), which the IRS estimates will take more than five hours.

CHAPTER 9 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following groups was the original target of the alternative minimum tax:
 - a) middle income earners
 - b) persons with substantial income
 - c) the working poor
 - d) wealthy retirees
2. Children are not subject to AMT rules.
 - a) true
 - b) false
3. AMT pass-through items are required to be reported on each shareholder's or partner's tax return.
 - a) true
 - b) false
4. The Minimum Tax Credit (MTC) can be carried forward or back indefinitely.
 - a) true
 - b) false
5. What is the first step a taxpayer must take in determining if they are liable for AMT:
 - a) completion of the IRS's 12-line AMT worksheet
 - b) calculation of their regular tax liability
 - c) computation of the AMT on Form 6251
 - d) determine their exemption amount based upon their filing status

CHAPTER 9 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Although this group is often hit with the AMT, it was not intended to reach this group when enacted.

B: Correct. Congress wanted to ensure that this group did not avoid paying taxes through exclusions, deductions or other means.

C: Incorrect. To the contrary, the law was aimed at those with very high incomes.

D: Incorrect. Only those with significant income were targeted, not the retired who were already wealthy.

(See page 9-1 of the course material.)

2. A: True is incorrect. Children are subject to the AMT rules of IRC § 55 through IRC § 59.

B: False is correct. Under the AMT rules, children are not allowed the normal AMT exemption for single individuals, but are allowed an exemption for AMT purposes of \$6,700, plus earned income.

(See page 9-2 of the course material.)

3. **A: True is correct.** The allocation for these items should follow the regular tax allocation rules.

B: False is incorrect. For partnerships and S corporations, AMT pass-through items are required to be reported on each of the shareholder's or partner's tax returns.

(See page 9-4 of the course material.)

4. A: True is incorrect. The MTC can be carried forward only. It is carried forward indefinitely until used in full.

B: False is correct. The MTC is the difference between the AMT computed "with exclusion and deferral items" in the usual manner and the AMT computed using only exclusion items, or "without deferral preferences." It can be carried forward indefinitely, but it cannot be carried back.

(See page 9-5 of the course material.)

5. A: Incorrect. This is the second, not the first step in the analysis.

B: Correct. The regular income tax rules include preferred treatment for certain income and provide for specified exclusion, deduction and credits which must first be calculated.

C: Incorrect. This is later in the process.

D: Incorrect. This is a much later step.

(See pages 9-8 to 9-9 of the course material.)

Chapter 10: Tax Implications of Marriage and Divorce

Marriage and divorce can result in many changes to an individual's financial goals and plans. It is therefore important to understand the rules affecting the classification of marital property and how the life-changing events of both marriage and divorce can affect things such as ownership of assets and income tax liabilities.

I. Distinguishing Community and Separate Property

A. DEFINING COMMUNITY PROPERTY

Community property is a classification-based system that divides all marital assets into one of two categories:

- ✓ Community Property; and
- ✓ Separate Property.

1. Community Property

Except as otherwise provided by statute, all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in a community property state is community property. The law in community property states generally creates a presumption that any property acquired during the course of a marriage is community property.

This presumption places the burden of proof on the party challenging such a classification to come up with evidence to show that the property in question should be classified as separate property. Such evidence includes:

- ❑ Showing that the property was acquired by gift, devise, or bequest;
- ❑ Tracing the property to separate property assets; or
- ❑ Showing a clear agreement between the parties regarding the nature of the property.

The law may differ somewhat in each community property state. Also remember that the term "property" refers to both real and personal property of all types, including stocks, bonds, jewelry and cash.

B. SEPARATE PROPERTY

Simply put, property which is not community property is separate property. This includes property acquired prior to marriage and not gifted to the community, inheritances received during the marriage (so long as they are not subsequently commingled) and certain insurance proceeds. California, for example, defines separate property as all of the following:

- ❑ All property owned by the person before marriage;
- ❑ All property acquired by the person after marriage by gift, bequest, devise, or descent;
- ❑ The rents, issues, and profits of the property described in this section;
- ❑ A married person may, without the consent of the person's spouse, dispose of the property at will; and
- ❑ The earnings and accumulations of a spouse and the minor children living with, or in the custody of, the spouse, while living separate and apart from the other spouse are the separate property of that spouse.

1. Determining Date of Separation

The date of separation for the purposes of determining the character of property is established when either of the parties does not intend to resume the marriage and his or her actions bespeak the finality of the marital relationship.

2. Presumed Gift

Where one party contributes a separate asset to the community, it is presumed to be a gift to the community and will not be reimbursed unless there was an agreement which can be shown to the contrary.

3. Separate Property Business

A separate property business that is improved through the marriage is divisible upon divorce. In deciding how much of the business belongs to the community and how much is still classified as separate property depends on how much time the owner spouse spent on the business during the course of the marriage. Where the value of the business increased largely due to the efforts of the spouse during the marriage, more of the business will be considered community property at the time of divorce.

Example 1.

Hal owned a successful investment company at the time he met and married Sarah. After they were married, Hal worked full-time at the company. After 20 years of marriage, Hal filed for divorce. Under these facts, a large portion of the value of the business will be considered community property.

Example 2.

Lara was a CPA who also owned a 35 percent share of a local restaurant at the time she met and married Lawrence. Lara was a silent partner in the restaurant and continued her job as a CPA during the entire course of the 10-year marriage. Lawrence filed for divorce. The court is not likely to consider much of the restaurant ownership to be community property since Lara did not spend much of her time during the marriage working on the investment.

4. Management and Control

Each spouse has management control of the community property to the same degree he or she has control of his or her own separate property. If the parties want to alter their community property rights, such agreement must be executed in writing.

5. Change of Form

The original characterization of the property as community or separate does not change although the property may change its form.

Example.

Bill and Marci have been married for 10 years. In recognition of his five years of service at his place of employment, Bill receives a \$5,000 bonus. The money is received as compensation for his services rendered during the course of the marriage and therefore is community property. Bill takes the \$5,000 and opens a brokerage account. He uses the funds to purchase shares of Microsoft. The shares are community property, even if the brokerage account is in his name only.

C. COMMUNITY PROPERTY STATES

The following are community property states:

- ☐ Arizona;
- ☐ California;
- ☐ Idaho;
- ☐ Louisiana;
- ☐ Nevada;
- ☐ New Mexico;
- ☐ Texas;
- ☐ Washington; and
- ☐ Wisconsin.

Whether a person has community property and community income depends on the state where he or she is domiciled. Each individual has only one domicile, regardless of the number of homes each person owns or occupies. A person's domicile is defined as the permanent legal home that he or she intends to use for an indefinite or unlimited period, and to which, when absent, he or she intends to return. The question of domicile is therefore largely a matter of intent.

Persons must be prepared to show with facts that he or she intends a given place or state to be their permanent home. If a person moves into or out of a community property state during the year, they may or may not have community income. Factors considered in determining domicile include:

- ❑ Where the individual pays state income tax;
- ❑ Where the individual votes;
- ❑ Location of property he or she owns;
- ❑ Citizenship;
- ❑ Length of residence; and
- ❑ Business and social ties to the community.

The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home or residence may continue for months or years while a domicile may be established the first moment a person occupies the property. A person's intent is the determining factor in proving where they are domiciled.

D. PRENUPTIAL AGREEMENTS

A prenuptial agreement is nothing more than a contract between two persons that governs the distribution of marital assets at the time of dissolution rather than the state's laws. They are generally enforceable so long as they comply with the laws governing enforcement of contracts. However, prenuptial agreements are not generally valid if the party against whom enforcement of the contract is able to prove:

- ❑ That party did not execute the agreement *voluntarily; and*
- ❑ The agreement was *unconscionable* and all of the following apply:
 - He or she was not provided disclosure of the property of the other;
 - He or she did not voluntarily waive, in writing, any right to the disclosure;
 - He or she did not have an adequate knowledge of the property of the other; and
 - The agreement is against public policy by encouraging, facilitating or promoting divorce or dissolution.

E. MISCELLANEOUS ISSUES

1. Installment and Credit Acquisitions

When one spouse before marriage executes an installment contract to purchase property and then uses community funds after marriage to pay some of the installment, the community property is entitled to an interest in such property in the proportion that community funds were used for installments.

If one spouse acquires property on credit during the marriage, it is presumed to be community property. To rebut this presumption, the courts will consider the intent of the lender. If the lender intended to extend the credit based on the separate assets of one spouse, the property will be characterized as separate.

2. Personal Injury Damage Awards

The money received is community property if the injury occurs during the marriage, however, upon separation the funds received from personal injury awards shall be assigned entirely to the party who suffered the injury.

There is no offset to the community property for funds awarded to the separate property of the injured party.

3. Pension Plans and Retirement

Pensions are divisible whether they are vested or not. The funds will be apportioned between those that were accumulated or earned during the marriage and those that were earned before or after the end of the marriage.

II. Federal Taxation: Community or Separate Property Income

A. DETERMINING THE CHARACTER OF ASSETS

The laws of the state in which a person is domiciled generally govern whether they have community property and community income or separate property and separate income for federal tax purposes. Table 10-1, later, summarizes the general rules.

1. Certain Community Income

Community property laws may not apply to an item of community income. An individual is responsible for reporting all of it if:

- ☐ They treat the item as if only they are entitled to the income, and
- ☐ They do not notify their spouse of the nature and amount of the income by the due date for filing the return (including extensions).

2. Relief From Separate Return Liability for Community Income

Individuals are not responsible for reporting an item of community income if all the following conditions exist:

- ☐ They file a separate return for the tax year;
- ☐ They do not include an item of community income in gross income on their separate return;
- ☐ They establish that they did not know of, and had no reason to know of, that community income; and
- ☐ Under all facts and circumstances, it would not be fair to include the item of community income in the person's gross income.

3. Equitable Relief

Persons who were married and filed a separate return in a community property state and are now liable for an underpayment or understatement of tax may request equitable relief if they believe the liability belongs to his or her spouse or former spouse.

4. Spousal Agreements

In some states a husband and wife may enter into an agreement that affects the status of property or income as community or separate property. Refer to individual state law to determine how it might affect your clients.

5. Nonresident Alien Spouse

If an individual is a United States citizen or resident and chooses to treat his or her nonresident alien spouse as a U.S. resident for tax purposes and is domiciled in a community property state or country, community property rules apply. In such cases, the couple must file a joint return for the year such a choice is made. Separate returns can be filed for later years.

If an individual is a U.S. citizen or resident and chooses *not* to treat his or her nonresident alien spouse as a U.S. resident for tax purposes, community property income is treated in the manner described below in the section covering spouses living apart all year. However, the person need not meet the conditions outlined in that section.

B. SPOUSES LIVING APART ALL YEAR

If a person is married at any time during the calendar year, special rules apply for reporting certain community income. Persons must meet *all* the following conditions for these special rules to apply:

- ☐ The individual and their spouse lived apart all year;
- ☐ The individual and their spouse did not file a joint return for a tax year beginning or ending in the calendar year;

- ❑ The individual and/or their spouse had earned income for the calendar year that is community income; and
- ❑ The individual and their spouse did not transfer, directly or indirectly, any of the earned income between themselves before the end of the year. They should not take into account transfers of very small amounts or value, or a payment or transfer to or for any dependent child, even though the payment or transfer satisfies an obligation of support imposed on the spouse.

Table 10-1. General Rules - Property and Income: Community or Separate?

<p>Community property is property:</p> <ul style="list-style-type: none"> • That you, your spouse, or both acquire during your marriage while you are domiciled in a community property state. This includes the part of the property bought with community property funds if part was bought with community funds and part with separate property funds; • That you and your spouse agreed to convert from separate to community property; and • That cannot be identified as separate property. 	<p>Separate property is:</p> <ul style="list-style-type: none"> • Property that you or your spouse owned separately before marriage; • Money earned while domiciled in a non-community property state; • Property either of you were given or inherited separately after marriage; • Property bought with separate funds, or exchanged for separate property, during the marriage; • Property that you and your spouse agreed to convert from community into separate property in an agreement valid under state law; and • The part of property bought with separate funds, if part was bought with separate and part with community property funds.
<p>Community income¹ is income from:</p> <ul style="list-style-type: none"> • Community property. • Salaries, wages, or pay for services of you, your spouse, or both during your marriage. • Real estate that is treated as community property under the laws of the state where the property is located. 	<p>Separate income¹ is income from:</p> <ul style="list-style-type: none"> • Separate property. Separate income belongs to the spouse who owns the property.

¹ In Idaho, Louisiana, Texas, and Wisconsin, income from most separate property is community income.

If all these conditions are met, an individual and their spouse must report community income.

1. Earned Income

Treat earned income that is not trade or business or partnership income as the income of the spouse who performed the services. Earned income means wages, salaries, professional fees, and other pay for personal services. Earned income does not include any social security or social security equivalent of tier 1 railroad retirement benefits received during the year.

2. Trade or Business Income

Treat income and related deductions from a trade or business that is not a partnership as those of the person carrying on the trade or business.

3. Partnership Income or Loss

Treat income or loss from a trade or business carried on by a partnership as the income or loss of the spouse who is the partner.

4. Separate Property Income

Treat investment income from the separate property of one spouse as the income of that spouse.

5. Social Security Benefits

Treat social security benefits received during the year, including the social security equivalent portion of tier 1 railroad retirement benefits, as the separate income of the spouse who received them.

6. Other Income

Treat all other community income, such as dividends, interest, rents, royalties, or gains, according to the community property laws of the individual's state or country.

Example.

Daniel and Sharon were married throughout the year but did not live together at any time during the year. Both were domiciled in Texas, a community property state. They did not file a joint return or transfer any earned income between themselves. During the year their incomes were as follows:

	<u>Daniel</u>	<u>Sharon</u>
Wages	\$20,000	\$22,000
Consulting business fees	5,000	
Partnership income		10,000
Dividends from separate property	1,000	2,000
Interest from community property	<u>500</u>	<u>500</u>
Total	<u>\$26,500</u>	<u>\$34,500</u>

Under Texas community property laws, all of Daniel and Sharon's income is considered community income. Sharon did not take part in Daniel's consulting business.

Ordinarily, Daniel and Sharon would each report half the total community income, \$30,500 $[(\$26,500 + \$34,500) \div 2]$, on their separate returns. But because they meet the four conditions discussed earlier, they must disregard community property law when reporting their income, except the interest from community property. They should report on their separate returns only their own earnings and other income and their share of the interest from community property. Daniel reports \$26,500 and Sharon reports \$34,500.

C. END OF THE MARITAL COMMUNITY

The marital community may end in several ways. When the marital community ends, the community assets (money and property) are divided between the spouses.

1. Death of Spouse

In community property states, each spouse usually is considered to own half the estate (excluding separate property). If one spouse dies, the total fair market value (FMV) of the community property, including the part that belongs to the surviving spouse, generally becomes the basis of the entire property. For this rule to apply, at least half the value of the community property interest must be includible in the decedent spouse's gross estate, whether or not the estate must file a return.

Example.

Bob and Ann owned community property that had a basis of \$80,000. When Bob died, his and Ann's community property had an FMV of \$100,000. At least half their community interest was includible in Bob's estate. The basis of Ann's half of the property is \$50,000 after Bob died (one half of the \$100,000 FMV). The basis of the other half to Bob's heirs is also \$50,000.

2. Divorce or Separation

The division of community property in connection with a divorce or property settlement does not result in a gain or loss. Each spouse is taxed on half the community income for the part of the year before the community ends. Any income received after the marital community ends is separate income. This separate income is taxable only to the spouse to whom it belongs.

An absolute decree of divorce or annulment ends the marital community in all community property states. A decree of annulment, even though it holds that no valid marriage ever existed, usually does not nullify community property rights arising during the so-called *marriage*.

A decree of legal separation or of separate maintenance may or may not end the marital community. The court in the state issuing the decree may terminate the marital community and divide the property between the spouses.

A separation agreement may divide the community property between spouses. It may provide that this property along with future earnings and property acquired will be separate property. Such an agreement may end the community. In some states, the marital community ends when the husband and wife permanently separate, even if there is no formal agreement.

D. FEDERAL INCOME TAX PREPARATION

The following discussion does not apply to spouses who meet the conditions under spouses living apart all year, discussed earlier. Those spouses must report their community income.

1. Joint Return Versus Separate Returns

Ordinarily, filing a joint return will give a couple the greater tax advantage. But in some cases, the couple's combined income tax on separate returns may be less than it would be on a joint return. If a couple elects to file separate returns, they should:

- ☐ Itemize deductions if their spouse itemizes deductions, because they cannot claim the standard deduction;
- ☐ They cannot take the credit for child and dependent care expenses in most instances;
- ☐ They cannot take the earned income credit;
- ☐ They cannot exclude any interest income from U.S. savings bonds that they used for higher education expenses;
- ☐ They cannot take the credit for the elderly or the disabled unless they lived apart from each other all year;
- ☐ They may have to include in income more of the social security benefits (including any equivalent railroad retirement benefits) they received during the year than they would on a joint return;
- ☐ They cannot deduct interest paid on a qualified student loan;
- ☐ They cannot take the education credits (the Hope and lifetime learning credits);
- ☐ They may have a smaller child tax credit than they would on a joint return; and
- ☐ They cannot take the exclusion or credit for adoption expenses in most instances.

Individuals should calculate their tax both on a joint return and on separate returns under the community property laws of their state. Individuals can then compare the tax figured under both methods and use the one that results in less tax.

If the couple files separate returns, each spouse must each report half of their combined community income and deductions in addition to each individual's separate income and deductions. Each spouse should list only their share of the income and deductions on the appropriate lines of their separate tax returns (wages, interest, dividends, etc.).

E. IDENTIFYING INCOME AND DEDUCTIONS

To figure the best way to file a return – jointly or separately – individuals first identify the community and separate income and deductions according to the laws of the applicable state.

Community income exempt from federal tax generally keeps its exempt status for both spouses. For example, under certain circumstances, income earned outside the United States is tax exempt. If an individual earned income and met the conditions that made it exempt, the income is also exempt for their spouse even though he or she may not have met the conditions.

1. Military Retirement Pay

State community property laws apply to military retirement pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the member of the Armed Forces was in active military service.

Pay earned while married and domiciled in a community property state is community income. This income is considered to be received half by the member of the Armed Forces and half by the spouse.

2. Civil Service Retirement

For income tax purposes, community property laws apply to annuities payable under the Civil Service Retirement Act (CSRS) or Federal Employee Retirement System (FERS).

Whether a civil service annuity is separate or community income depends on the marital status and domicile of the employee when the services were performed for which the annuity is paid. Even if you now live in a non-community property state and you receive a civil service annuity, it may be community income if it is based on services performed while married and domiciled in a community property state.

If a civil service annuity is a mixture of community income and separate income, it must be divided between the two kinds of income. The division is based on the employee's domicile and marital status in community and non-community property states during his or her periods of service.

Example.

Henry Wright retired this year after 30 years of civil service. He and his wife were domiciled in a community property state during the past 15 years. Since half the service was performed while the Wrights were married and domiciled in a community property state, half the civil service retirement pay is considered to be community income. If Mr. Wright receives \$1,000 a month in retirement pay, \$500 is considered community income - half (\$250) is his income and half (\$250) is his wife's.

3. Lump-Sum Distributions

If an individual receives a lump-sum distribution from a qualified retirement plan, they may be able to choose an optional method of figuring the tax on the distribution. For the 10-year tax option, they must disregard community property laws. (A 5-year option was repealed for tax years beginning after December 31, 1999.)

4. Gains and Losses

Gains and losses are classified as separate or community depending on how the property is held. For example, a loss on separate property, such as stock held separately, is a separate loss. On the other hand, a loss on community property, such as a casualty loss to an individual's home held as community property, is a community loss.

5. Business and Investment Expenses

If separate returns are filed, expenses incurred to earn or produce:

- ❑ Community business or investment income are generally divided equally between spouses. Each spouse is entitled to deduct one-half of the expenses on their separate returns, or
- ❑ Separate business or investment income are deductible by the spouse who earns the income.

Other limits may also apply to business and investment expenses.

6. Personal Expenses

Expenses that are paid out of separate funds, such as medical expenses, are deductible by the spouse who pays them. If these expenses are paid from community funds, each spouse must divide the deduction equally.

7. Individual Retirement Accounts

There are several kinds of individual retirement arrangements (IRAs). They are traditional IRAs (including SEP-IRAs), SIMPLE IRAs, and Roth IRAs. Community property laws do not apply to IRAs or Coverdell ESAs.

8. Personal Exemptions and Dependents

When spouses file separate returns, they must claim their own exemptions for that year. The spouses cannot divide the amount allowed as an exemption for a dependent between them. When community funds provide over one-half of the support for more than one person who otherwise qualifies as a dependent, the spouses may divide the number of dependency exemptions as explained in the following example.

Example.

Ron and Diane White have three dependent children and live in Nevada. If Ron and Diane file separately, only Ron can claim his own exemption, and only Diane can claim her own exemption. Ron and Diane can agree that one of them will claim the exemption for one, two, or all of their children and the other will claim any remaining exemptions. They cannot each claim half of the total exemption amount for their three children.

9. Self-Employment Tax

If any income from a trade or business other than a partnership is community income under state law, it is subject to self-employment tax as the income of the spouse carrying on the trade or business.

10. Partnership Income

If one spouse is a partner and their distributive share of any income or loss from a trade or business carried on by the partnership is community income, they should treat their share as their net earnings from self-employment. No part is treated as net earnings from self-employment by their spouse. If both spouses are partners, each must claim their share when figuring net earnings from self-employment for self-employment tax purposes.

If separate returns are made by a husband and wife domiciled in a community property state, and only one spouse is a member of the partnership, the part of his or her distributive share of any item (not considered net earnings from self-employment), which is community property or which is derived from community property, should be reported by the husband and wife in equal shares.

CHAPTER 10 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter

1. Is all property acquired by a married couple living in a community property state always community property:
 - a) yes; this is a non-rebuttable presumption
 - b) yes, unless the couple has a prenuptial agreement
 - c) there is a presumption that such property is community property but it can be rebutted
 - d) only in the case of long-term marriages
2. What rule is used to determine when a couple has separated for purposes of dividing their assets:
 - a) not until one party files for divorce
 - b) not until the divorce decree becomes final
 - c) when both parties determine they will no longer continue the marriage whether or not legal paperwork has been filed
 - d) when one person walks out on the other
3. For purposes of community property, a person's domicile is defined as the place where the individual spends the most time.
 - a) true
 - b) false
4. A contract that controls the distribution of property in the event of a divorce is referred to as a:
 - a) really good idea
 - b) prenuptial agreement
 - c) dissolution contract
 - d) contract in perpetuity

5. The division of community property in connection with a divorce or property settlement does not result in a gain or a loss.
- a) true
 - b) false
6. Ordinarily, filing a joint return will give a couple the greater tax advantage.
- a) true
 - b) false

CHAPTER 10 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. This is a presumption only but it is certainly rebuttable.

B: Incorrect. A prenuptial agreement controls disposition of assets in the event of a divorce, but the presumption is rebuttable even without such an agreement.

C: Correct. The burden is on the party objecting to the classification to show that the property is in fact separate property.

D: Incorrect. There is a rebuttable presumption regardless of the length of the marriage.

(See page 10-1 of the course material.)

2. A: Incorrect. It is the intent of the parties that controls the date of separation and not when legal paperwork is actually filed.

B: Incorrect. The intent of the parties to permanently separate is the controlling factor. That is long before the final divorce decree is obtained.

C: Correct. This time, whether or not papers have been filed, is used to classify property as separate or community.

D: Incorrect. The event of one person walking out on the other would not indicate the date of separation, unless that signals the intent of both parties to permanently separate.

(See page 10-2 of the course material.)

3. A: True is incorrect. A person's domicile is defined as the permanent legal home that the person intends to use for an indefinite or unlimited period, and to which, when absent, he or she intends to return.

B: False is correct. The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home or residence may continue for months or years while a domicile may be established the first moment a person occupies the property. A person's intent is the determining factor in proving where they are domiciled.

(See pages 10-3 to 10-4 of the course material.)

4. A: Incorrect. It might be a good idea in certain cases, but that is not what the contract is called.

B: Correct. This type of contract controls how assets of the community will be distributed in the event there is a divorce. It supersedes the community property or other laws of the couple's state of domicile.

C: Incorrect. This is not the correct term.

D: Incorrect. This is not the correct term.

(See page 10-4 of the course material.)

5. **A: True is correct.** Each spouse is taxed on half the community income for the part of the year before the community ends. Any income received after the marital community ends is separate income.

B: False is incorrect. No gain or loss results from the division of community property. Each spouse is taxed on their portion of the community income before the community ends.

(See page 10-9 of the course material.)

6. **A: True is correct.** Individuals should calculate their tax both on a joint return and on separate returns under the community property laws of their state, and then compare the tax figured under both methods and use the one that results in less tax.

B: False is incorrect. If the couple files separate returns, each spouse must report half of the combined community property income and deductions in addition to each individual's separate income and deductions.

(See page 10-10 of the course material.)

Part II

Income Tax Considerations in Retirement Planning

Chapter 11: Employer-Sponsored Retirement Plans

I. Introduction and Overview

Virtually every detailed financial plan includes provisions for retirement. One important way in which people can save for retirement is through the savings of pre-tax dollars. This has the double benefit of providing an important source of retirement funding and of limiting income tax liability in the present time. This chapter discusses retirement plans small business owners can set up and maintain for themselves and their employees. The following types of retirement plans are covered:

- ❑ SEP (simplified employee pension) plans;
- ❑ SIMPLE (savings incentive match plan for employees) plans; and
- ❑ Qualified plans (also called H.R. 10 plans or Keogh plans when covering self-employed individuals).

SEP, SIMPLE, and qualified plans offer small business owners and their employees a tax-favored way to save for retirement. Employers can deduct contributions made to the plan for their employees. A sole proprietor can deduct contributions he or she makes to the plan for himself or herself.

Trustees' fees can also be deducted if contributions to the plan do not cover them. Earnings on the contributions are generally tax-free until an employer or his or her employees receive distributions from the plan.

Under certain plans, employees can have their employer contribute limited amounts of their before-tax pay to a plan. These amounts (and earnings on them) are generally tax free until the employees receive distributions from the plan. The following is a summary of each type of plan.

A. SEP PLANS

SEPs provide a simplified method for an employer to make contributions to a retirement plan for employees. Instead of setting up a profit-sharing or money purchase plan with a trust, an employer can adopt a SEP agreement and make contributions directly to a traditional individual retirement account or a traditional individual retirement annuity (SEP-IRA) set up for each eligible employee.

B. SIMPLE PLANS

A SIMPLE plan can be set up by an employer who had 100 or fewer employees who received at least \$5,000 in compensation from the employer for the preceding calendar year and who meets certain other requirements. Under a SIMPLE plan, employees can choose to make salary reduction contributions rather than receiving these amounts as part of their regular pay. In addition, the employer will contribute matching or nonelective contributions. The two types of SIMPLE plans are the SIMPLE IRA plan and the SIMPLE 401(k) plan.

C. QUALIFIED PLANS

The qualified plan rules are more complex than the SEP plan and SIMPLE plan rules. However, there are advantages to qualified plans, such as increased flexibility in designing plans and increased contribution and deduction limits in some cases.

II. Simplified Employee Pension (SEP) Plans

A simplified employee pension (SEP) is a written plan that allows employers to make contributions toward their own retirement (if they are self-employed) and their employees' retirement without getting involved in a more complex qualified plan. Under a SEP, employers make the contributions to a traditional individual retirement arrangement (called a SEP-IRA) set up by or for each eligible employee. A SEP-IRA is owned and controlled by the employee, and employers make contributions to the financial institution where the SEP-IRA is maintained.

A. ELIGIBILITY REQUIREMENTS

SEP-IRAs are set up for, at a minimum, each eligible employee. A SEP-IRA may have to be set up for a leased employee, but does not need to be set up for excludable employees, discussed later.

1. Eligible Employee

An eligible employee is an individual who meets all the following requirements:

- ☐ Has reached age 21;
- ☐ Has worked for the employer in at least three of the last five years; and
- ☐ Has received at least \$500 (indexed) in compensation for the current year.

Employers can use less restrictive participation requirements than those listed, but not more restrictive ones.

2. Excludable Employees

The following employees can be excluded from coverage under a SEP:

- ☐ Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer; and
- ☐ Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from the employer.

B. SETTING UP A SEP

There are three basic steps in setting up a SEP:

- ☐ Execution of a formal written agreement to provide benefits to all eligible employees;
- ☐ Providing each eligible employee with certain information about the SEP; and
- ☐ Establishing a SEP-IRA by or for each eligible employee.

1. Formal Written Agreement

Employers must execute a formal written agreement to provide benefits to all eligible employees under a SEP. This requirement can be satisfied by adopting an IRS model SEP using Form 5305-SEP.

If an employer adopts an IRS model SEP using Form 5305-SEP, no prior IRS approval or determination letter is required. However, employers cannot use Form 5305-SEP if any of the following apply:

- ☐ They currently maintain any other qualified retirement plan. This does not prevent them from maintaining another SEP;
- ☐ They have any eligible employees for whom IRAs have not been set up;
- ☐ They use the services of leased employees;
- ☐ They are a member of any of the following unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP:
 - An affiliated service group described in § 414(m);
 - A controlled group of corporations described in § 414(b); and
 - Trades or businesses under common control described in § 414(c); or
- ☐ They do not pay the cost of the SEP contributions.

2. Information Provided to Employees

Employers must give each eligible employee a copy of Form 5305-SEP, its instructions, and the other information listed in the Form 5305-SEP instructions. An IRS model SEP is not considered adopted until each employee has been given this information.

3. Establishing Plan for Each Employee

A SEP-IRA must be set up by or for each eligible employee. SEP-IRAs can be set up with banks, insurance companies, or other qualified financial institutions. Employers send SEP contributions to the financial institution where the SEP-IRA is maintained. Employers can set up a SEP for a year as late as the due date (including extensions) of their income tax return for that year.

C. CONTRIBUTION RULES

The SEP rules permit employers to contribute a limited amount of money each year to each employee's SEP-IRA. If they are self-employed, they can contribute to their own SEP-IRA. Contributions must be in the form of money (cash, check, or money order); property cannot be contributed. However, participants may be able to transfer or roll over certain property from one retirement plan to another.

Employers do not have to make contributions every year. But if they make contributions, they must be based on a written allocation formula and must not discriminate in favor of highly compensated employees. When contributions are made, the employer must contribute to the SEP-IRAs of all participants who actually performed personal services during the year for which the contributions are made, even employees who die or terminate employment before the contributions are made.

Contributions made under a SEP are treated as if made to a qualified pension, stock bonus, profit-sharing, or annuity plan. Consequently, contributions are deductible within limits, and generally are not taxable to the plan participants. A SEP-IRA cannot be designated as a Roth IRA. Employer contributions to a SEP-IRA will not affect the amount an individual can contribute to a Roth IRA. To deduct contributions for a year, the employer must make the contributions by the due date (including extensions) of their tax return for the year.

1. Contribution Limits

Contributions limits are established for each year. For example, contributions made for 2008 to a common-law employee's SEP-IRA could not exceed the lesser of 25% of the employee's compensation or \$46,000 (\$49,000 for 2009). Compensation generally does not include the employer's contributions to the SEP.

2. Self-Contributions

The annual limits on contributions to a common-law employee's SEP-IRA also apply to contributions employers make to their own SEP-IRA. However, special rules apply when figuring the maximum deductible contribution.

3. Annual Compensation Limit

Employers cannot consider the part of an employee's compensation over \$230,000 (2008) when figuring the contribution limit for that employee. However, \$46,000 is the maximum contribution for an eligible employee. (The annual compensation limit of \$230,000 increased to \$245,000 for 2009.)

If an employer contributes to a defined contribution plan, annual additions to an account are limited to the lesser of \$46,000 or 100% of the participant's compensation. When figuring this limit, employers must add their contributions to all defined contribution plans. Because a SEP is considered a defined contribution plan for this limit, contributions to a SEP must be added to contributions to other defined contribution plans.

4. Tax Treatment of Excess Contributions

Excess contributions are contributions to an employee's SEP-IRA (or to the employer's own SEP-IRA) that exceed the amount allowed for that particular year.

Excess contributions are included in the employee's income for the year and are treated as contributions by the employee to his or her SEP-IRA.

D. DEDUCTING CONTRIBUTIONS

Generally, individuals can deduct the contributions made each year to each employee's SEP-IRA. If the employer is self-employed, they can deduct the contributions made each year to their own SEP-IRA.

1. Deduction Limit for Contributions for Participants

Federal law annually establishes a cap on how much an employer can deduct for their contributions (other than elective deferrals) for participants. In 2008, for example, it was the lesser of the following amounts:

- ❑ The employer's contributions (including any excess contributions carryover); and
- ❑ 25% of the compensation (limited to \$230,000 per participant) paid to the participants during 2008 from the business that has the plan, not to exceed \$46,000 per participant.

In 2009, the \$230,000 and \$46,000 amounts above increased to \$245,000 and \$49,000.

2. Deduction Limit for Self-Employed Individuals

If an employer contributes to their own SEP-IRA, they must make a special computation to figure their maximum deduction for these contributions. When figuring the deduction for contributions made to one's own SEP-IRA, compensation is the individual's net earnings from self-employment, which takes into account both the following deductions:

- ❑ The deduction for one-half of the individual's self-employment tax; and
- ❑ The deduction for contributions to their own SEP-IRA.

The deduction for contributions to one's own SEP-IRA and their net earnings depend on each other. For this reason, an individual determines the deduction for contributions to their own SEP-IRA indirectly by reducing the contribution rate called for in their plan.

3. Deduction Limits for Multiple Plans

For the deduction limits, employers must treat all of their qualified defined contribution plans as a single plan and all of their qualified defined benefit plans as a single plan. If an employer has both kinds of plans, a SEP is treated as a separate profit-sharing plan.

If an employer also contributes to a qualified defined contribution plan, they must reduce the 25% deduction limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP plan and the defined contribution plan.

4. Carryover of Excess SEP Contributions

If an employer made SEP contributions that are more than the deduction limit (nondeductible contributions), they can carry over and deduct the difference in later years. However, the carryover, when combined with the contribution for the later year, is subject to the deduction limit for that year. If an employer made nondeductible (excess) contributions to a SEP, they may be subject to a 10% excise tax.

5. When To Deduct Contributions

When an employer can deduct contributions made for a year depends on the tax year on which the SEP is maintained. If the SEP is maintained on a calendar year basis, the employer can deduct contributions made for a year on their tax return for the year with or within which the calendar year ends. If the employer files their tax return and maintains the SEP using a fiscal year or short tax year, they may deduct contributions made for a year on their tax return for that year.

Example.

WillCo is a fiscal year taxpayer whose tax year ends June 30. WillCo maintains a SEP on a calendar year basis. WillCo deducts SEP contributions made for calendar year 2007 on their tax return for the tax year ending June 30, 2008.

E. SALARY REDUCTION SIMPLIFIED EMPLOYEE PENSION (SARSEP)

A SARSEP is a SEP set up before 1997 that includes a salary reduction arrangement. Under a SARSEP, employees can choose to have the employer contribute part of their pay to their SEP-IRAs rather than receive it in cash. This contribution is called an "elective deferral" because employees choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them. Employers are not allowed to set up a SARSEP after 1996. However, participants (including employees hired after 1996) in a SARSEP set up before 1997 can continue to have employers contribute part of their pay to the plan.

1. Who Can Have a SARSEP

A SARSEP set up before 1997 is available to an employer and their eligible employees only if all the following requirements are met.

- ❑ At least 50% of employees eligible to participate choose to make elective deferrals;
- ❑ The employer has 25 or fewer employees who were eligible to participate in the SEP at any time during the preceding year; and
- ❑ The elective deferrals of highly compensated employees meet the SARSEP ADP test.

2. SARSEP ADP Test

Under the SARSEP ADP test, the amount deferred each year by each eligible highly compensated employee as a percentage of pay (the deferral percentage) cannot be more than 125% of the average deferral percentage (ADP) of all non-highly compensated employees eligible to participate.

For figuring the deferral percentage, compensation is generally the amount the employer pays to the employee for the year. Compensation includes the elective deferral and other amounts deferred in certain employee benefit plans. Elective deferrals under the SARSEP are included in figuring an employees' deferral percentage even though they are not included in the income of employees for income tax purposes.

3. Limit on Elective Deferrals

The most a participant can choose to defer for each calendar year is established by the IRS. For example, in 2008 the amount was the lesser of the following amounts:

- ❑ 25% of the participant's compensation (limited to \$230,000 of the participant's compensation); or
- ❑ \$15,500.

In 2009, the compensation limit of \$230,000 increased to \$245,000. The \$15,500 amount increased to \$16,500.

The \$15,500 limit in 2008 applied to the total elective deferrals the employee makes for the year to a SEP and any of the following:

- ❑ Cash or deferred arrangement (section 401(k) plan);
- ❑ Salary reduction arrangement under a tax-sheltered annuity plan (section 403(b) plan); or
- ❑ SIMPLE IRA plan.

A SARSEP can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2008 was \$5,000 and increases to \$5,500 for 2009. However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts:

- ❑ The catch-up contribution limit; or
- ❑ The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

Catch-up contributions are not subject to the elective deferral limits.

4. Excess SEP Contributions

Excess SEP contributions are elective deferrals of highly compensated employees that are more than the amount permitted under the SARSEP ADP test. Employers must notify their highly compensated employees within 2½ months after the end of the plan year of their excess SEP contributions. If they do not notify them within this time period, they must pay a 10% tax on the excess.

5. Distributions (Withdrawals)

Employers cannot prohibit distributions from a SEP-IRA. Also, they cannot make contributions on the condition that any part of them must be kept in the account. Distributions are subject to IRA rules.

6. Additional Taxes

The tax advantages of using SEP-IRAs for retirement savings can be offset by additional taxes. There are additional taxes for all the following actions:

- ❑ Making excess contributions;
- ❑ Making early withdrawals; and
- ❑ Not making required withdrawals.

Also, a SEP-IRA may be disqualified, or an excise tax may apply, if the account is involved in a prohibited transaction. If an employee improperly uses his or her SEP-IRA, such as by borrowing money from it, the employee has engaged in a prohibited transaction. In that case, the SEP-IRA will no longer qualify as an IRA.

If a SEP-IRA is disqualified because of a prohibited transaction, the assets in the account will be treated as having been distributed to the employee on the first day of the year in which the transaction occurred. The employee must include in income the fair market value of the assets (on the first day of the year) that is more than any cost basis in the account. Also, the employee may have to pay the additional tax for making early withdrawals.

III. SIMPLE Plans

A savings incentive match plan for employees (SIMPLE plan) is a written arrangement that provides an employer and their employees with a simplified way to make contributions to provide retirement income. Under a SIMPLE plan, employees can choose to make salary reduction contributions to the plan rather than receiving these amounts as part of their regular pay. In addition, employers will contribute matching or

non-elective contributions. SIMPLE plans can only be maintained on a calendar-year basis. A SIMPLE plan can be set up in either of the following ways:

- ❑ Using SIMPLE IRAs (SIMPLE IRA plan); or
- ❑ As part of a 401(k) plan (SIMPLE 401(k) plan).

A. SIMPLE IRA PLAN

A SIMPLE IRA plan is a retirement plan that uses SIMPLE IRAs for each eligible employee. Under a SIMPLE IRA plan, a SIMPLE IRA must be set up for each eligible employee. An employer can set up a SIMPLE IRA plan if they meet both of the following requirements:

- ❑ They meet the employee limit; and
- ❑ They do not maintain another qualified plan unless the other plan is for collective bargaining employees.

1. Employee Limit

To be eligible to establish a SIMPLE IRA plan, the employer must have had 100 or fewer employees who received \$5,000 or more in compensation during the preceding year. Under this rule, employers must take into account all employees employed at any time during the calendar year regardless of whether they are eligible to participate. Employees include self-employed individuals who received earned income and leased employees. Once an employer sets up a SIMPLE IRA plan, they must continue to meet the 100-employee limit each year they maintain the plan.

If an employer maintains a SIMPLE IRA plan for at least 1 year and ceases to meet the 100-employee limit in a later year, they will be treated as meeting it for the 2 calendar years immediately following the calendar year for which they last met it. A different rule applies if the employer does not meet the 100-employee limit because of an acquisition, disposition, or similar transaction. Under this rule, the SIMPLE IRA plan will be treated as meeting the 100-employee limit for the year of the transaction and the two following years if both the following conditions are satisfied:

- ❑ Coverage under the plan has not significantly changed during the grace period; and
- ❑ The SIMPLE IRA plan would have continued to qualify after the transaction if the company had remained a separate employer.

2. Other Qualified Plan

The SIMPLE IRA plan generally must be the only retirement plan to which an employer makes contributions, or to which benefits accrue, for service in any year beginning with the year the SIMPLE IRA plan becomes effective. There is an exception so that if an employer maintains a qualified plan for collective bargaining employees they may also maintain a SIMPLE IRA plan for other employees.

3. Eligible Employees

Any employee who received at least \$5,000 in compensation during any 2 years preceding the calendar year in which the plan is in effect and is reasonably expected to receive at least \$5,000 during the current calendar year is eligible to participate. The term “employee” includes a self-employed individual who received earned income.

Employers can use less restrictive eligibility requirements (but not more restrictive ones) by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both. For example, an employer can allow participation for employees who received at least \$3,000 in compensation during any preceding calendar year. However, they cannot impose any other conditions for participating in a SIMPLE IRA plan.

4. Excludable Employees

The following employees do not need to be covered under a SIMPLE IRA plan:

- ❑ Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer; and
- ❑ Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from their employer.

5. Compensation

Compensation for employees is the total wages required to be reported on Form W-2. Compensation also includes the salary reduction contributions made under this plan, compensation deferred under a section 457 plan, and the employees' elective deferrals under a section 401(k) plan, a SARSEP, or a section 403(b) annuity contract. If a plan sponsor is self-employed, compensation is their net earnings from self-employment before subtracting any contributions made to the SIMPLE IRA plan for themselves.

B. SETTING UP A SIMPLE IRA PLAN

Employers can use Form 5304-SIMPLE or Form 5305-SIMPLE to set up a SIMPLE IRA plan. Each form is a model savings incentive match plan for employees (SIMPLE) plan document. Which form a particular employer uses depends on whether they select a financial institution or their employees select the institution that will receive the contributions.

Form 5304-SIMPLE is used when the employer allows each plan participant to select the financial institution for receiving his or her SIMPLE IRA plan contributions. Form 5305-SIMPLE is used if the employer requires that all contributions under the SIMPLE IRA plan be deposited initially at a designated financial institution.

The SIMPLE IRA plan is adopted when the employer completes all appropriate boxes and blanks on the form and it has been signed. It does not need to be filed with the IRS.

If an employer sets up a SIMPLE IRA plan using Form 5304-SIMPLE or Form 5305-SIMPLE, they can use the form to satisfy other requirements, including the following:

- ❑ Meeting employer notification requirements for the SIMPLE IRA plan; and
- ❑ Maintaining the SIMPLE IRA plan records and proving they set up a SIMPLE IRA plan for employees.

An employer can set up a SIMPLE IRA plan effective on any date from January 1 through October 1 of a year, provided they did not previously maintain a SIMPLE IRA plan. This requirement does not apply if the employer is a new employer that came into existence after October 1 of the year the SIMPLE IRA plan is set up and the employer set up a SIMPLE IRA plan as soon as administratively feasible after their business came into existence. If the employer had previously maintained a SIMPLE IRA plan, they can set up a SIMPLE IRA plan effective only on January 1 of a year. A SIMPLE IRA plan cannot have an effective date that is before the date an employer actually adopted the plan.

SIMPLE IRAs are the individual retirement accounts or annuities into which the contributions are deposited. A SIMPLE IRA must be set up for each eligible employee. A SIMPLE IRA cannot be designated as a Roth IRA. Contributions to a SIMPLE IRA will not affect the amount an individual can contribute to a Roth IRA. A SIMPLE IRA must be set up for an employee before the first date by which a contribution is required to be deposited into the employee's IRA.

C. NOTIFICATION AND ELECTION REQUIREMENTS

If an employer adopts a SIMPLE IRA plan, they must notify each employee of the following information before the beginning of the election period:

- ❑ The employee's opportunity to make or change a salary reduction choice under a SIMPLE IRA plan;
- ❑ The employer's choice to make either matching contributions or non-elective contributions;
- ❑ A summary description and the location of the plan; and
- ❑ Written notice that his or her balance can be transferred without cost or penalty if they use a designated financial institution.

The election period is generally the 60-day period immediately preceding January 1 of a calendar year (November 2 to December 31 of the preceding calendar year). However, the dates of this period are modified if the employer sets up a SIMPLE IRA plan in mid-year (for example, on July 1) or if the 60-day period falls before the first day an employee becomes eligible to participate in the SIMPLE IRA plan.

A SIMPLE IRA plan can provide longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements. For example, a SIMPLE IRA plan can provide a 90-day election period instead of the 60-day period. Similarly, in addition to the 60-day period, a SIMPLE IRA plan can provide quarterly election periods during the 30 days before each calendar quarter, other than the first quarter of each year.

D. CONTRIBUTION LIMITS

Contributions are made up of salary reduction contributions and employer contributions. The employer must make either matching contributions or non-elective contributions. No other contributions can be made to the SIMPLE IRA plan. These contributions, which the employer can deduct, must be made timely.

1. Salary Reduction Contributions

The amount the employee chooses to have their employer contribute to a SIMPLE IRA on his or her behalf are determined annually. They could not be more than \$10,500 for 2008 and \$11,500 for 2009. These contributions must be expressed as a percentage of the employee's compensation unless the employer permits the employee to express them as a specific dollar amount. The employer cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the annual dollar limit.

If an employee is a participant in any other employer plan during the year and has elective salary reductions or deferred compensation under those plans, the salary reduction contributions under a SIMPLE IRA plan also are elective deferrals that count toward the overall annual limit (e.g. \$15,500 for 2008) on exclusion of salary reductions and other elective deferrals.

2. Catch-up Contributions

A SIMPLE IRA plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2008 and 2009 is \$2,500. However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts:

- ❑ The catch-up contribution limit; or
- ❑ The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

3. Employer Matching Contributions

Employers are generally required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if the employer makes non-elective contributions as discussed later.

Example.

In 2008, employee John Rose earned \$25,000 and chose to defer 5% of his salary. The employer's net earnings from self-employment are \$40,000, and he chose to contribute 10% of his earnings to his SIMPLE IRA. The employer made 3% matching contributions. The total contribution the employer can make for John is \$2,000, figured as follows:

Salary reduction contributions (\$25,000 × .05)	\$1,250
Employer matching contribution (\$25,000 × .03)	<u>750</u>
Total contributions	\$2,000

The total contribution the employer can make for himself is \$5,200, figured as follows:

Salary reduction contributions (\$40,000 × .10)	\$4,000
Employer matching contribution (\$40,000 × .03)	<u>1,200</u>
Total contributions	\$5,200

4. Lower Percentage

If an employer chooses a matching contribution less than 3%, the percentage must be at least 1%. The employer must notify the employees of the lower match within a reasonable period of time before the 60-day election period for the calendar year. An employer cannot choose a percentage less than 3% for more than 2 years during the 5-year period that ends with (and includes) the year for which the choice is effective.

5. Non-elective Contributions

Instead of matching contributions, an employer can choose to make non-elective contributions of 2% of compensation on behalf of each eligible employee who has at least \$5,000 (or some lower amount the employer selects) of compensation for the year. If an employer makes this choice, they must make non-elective contributions whether or not the employee chooses to make salary reduction contributions. In 2008, for example, only \$230,000 of the employee's compensation could be taken into account to figure the contribution limit.

If an employer chooses this 2% contribution formula, they must notify the employees within a reasonable period of time before the 60-day election period for the calendar year.

6. Time Limits for Contributing Funds

Employers must make the salary reduction contributions to the SIMPLE IRA within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. Employers must make matching contributions or non-elective contributions by the due date (including extensions) for filing his or her federal income tax return for the year.

E. DEDUCTING CONTRIBUTIONS

1. When Contributions Can Be Deducted

Employers can deduct SIMPLE IRA contributions in the tax year with or within the calendar year for which contributions were made ends. The employer can deduct contributions for a particular tax year if they are made for that tax year and are made by the due date (including extensions) of the employer's federal income tax return for that year.

Example 1.

Employer A's tax year is the fiscal year ending June 30. Contributions under a SIMPLE IRA plan for the calendar year 2007 (including contributions made in 2007 before July 1, 2007) are deductible in the tax year ending June 30, 2008.

Example 2.

Bill is a sole proprietor whose tax year is the calendar year. Contributions under a SIMPLE IRA plan for the calendar year 2008 (including contributions made in 2009 by April 15, 2009) are deductible in the 2008 tax year.

2. Tax Treatment of Contributions

Employers can deduct contributions and their employees can exclude these contributions from their gross income. SIMPLE IRA contributions are not subject to federal income tax withholding. However, salary reduction contributions are subject to social security, Medicare, and federal unemployment (FUTA) taxes. Matching and non-elective contributions are not subject to these taxes.

3. Distributions (Withdrawals)

Distributions from a SIMPLE IRA are subject to IRA rules and generally are includible in income for the year received. Tax-free rollovers can be made from one SIMPLE IRA into another SIMPLE IRA. However, a rollover from a SIMPLE IRA to a non-SIMPLE IRA can be made tax free only after a 2-year participation in the SIMPLE IRA plan.

Early withdrawals generally are subject to a 10% additional tax. However, the additional tax is increased to 25% if funds are withdrawn within 2 years of beginning participation.

F. SIMPLE 401(K) PLANS

Employers can adopt a SIMPLE plan as part of a 401(k) plan if they meet the 100-employee limit. A SIMPLE 401(k) plan is a qualified retirement plan and generally must satisfy the rules discussed above. However, a SIMPLE 401(k) plan is not subject to the nondiscrimination and top-heavy rules in that discussion if the plan meets the conditions listed below:

- ❑ Under the plan, an employee can choose to have their employer make salary reduction contributions for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not more than the cap per year published by the IRS (\$10,500 for 2008 and \$11,500 for 2009). If permitted under the plan, an employee who is age 50 or over can also make a catch-up contribution up to the amount allowed for that year (up to \$2,500 for 2008 and 2009);
- ❑ The employer must make either:
 - Matching contributions up to 3% of compensation for the year; or
 - Non-elective contributions of 2% of compensation on behalf of each eligible employee who has at least \$5,000 of compensation from the employer for the year.
- ❑ No other contributions can be made to the trust;
- ❑ No contributions are made, and no benefits accrue, for services during the year under any other qualified retirement plan of the employer on behalf of any employee eligible to participate in the SIMPLE 401(k) plan; and
- ❑ The employee's rights to any contributions are nonforfeitable.

No more than \$230,000 (2008) of the employee's compensation can be taken into account in figuring salary reduction contributions, matching contributions, and nonelective contributions. The notification requirement that applies to SIMPLE IRA plans also applies to SIMPLE 401(k) plans.

IV. Qualified Plans

Qualified retirement plans set up by self-employed individuals are sometimes called Keogh or H.R.10 plans. A sole proprietor or a partnership can set up a qualified plan. A common-law employee or a partner cannot set up a qualified plan. The plans described in this section can also be set up and maintained by employers that are corporations. All the rules discussed here apply to corporations except where specifically limited to the self-employed.

The plan must be for the exclusive benefit of employees or their beneficiaries. A qualified plan can include coverage for a self-employed individual. A self-employed individual is treated as both an employer and an employee.

An employer can usually deduct, subject to limits, contributions made to a qualified plan, including those made for the employer's own retirement. The contributions (and earnings and gains on them) are generally tax free until distributed by the plan.

A. KINDS OF PLANS

There are two basic kinds of qualified plans – defined contribution plans and defined benefit plans – and different rules apply to each. An employer can have more than one qualified plan, but contributions to all the plans must not total more than the overall limits discussed later.

1. Defined Contribution Plan

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to that participant's account. Benefits are also affected by any income, expenses, gains, losses, and forfeitures of other accounts that may be allocated to an account. A defined contribution plan can be either a profit-sharing plan or a money purchase pension plan.

2. Profit-sharing Plan

A profit-sharing plan is a plan for sharing business profits with employees. However, an employer does not have to make contributions out of net profits to have a profit-sharing plan. The plan does not need to provide a definite formula for figuring the profits to be shared. But, if there is no formula, there must be systematic and substantial contributions.

The plan must provide a definite formula for allocating the contribution among the participants and for distributing the accumulated funds to the employees after they reach a certain age, after a fixed number of years, or upon certain other occurrences. In general, an employer can be more flexible in making contributions to a profit-sharing plan than to a money purchase pension plan or a defined benefit plan.

Forfeitures under a profit-sharing plan can be allocated to the accounts of remaining participants in a nondiscriminatory way or they can be used to reduce an employer's contributions.

3. Money Purchase Pension Plan

Contributions to a money purchase pension plan are fixed and are not based on a business's profits. For example, if the plan requires that contributions be 10% of the participants' compensation without regard to whether the employer has profits (or the self-employed person has earned income), the plan is a money purchase pension plan. This applies even though the compensation of a self-employed individual as a participant is based on earned income derived from business profits.

4. Defined Benefit Plan

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. Generally, small employers will need continuing professional help to have a defined benefit plan. Forfeitures under a defined benefit plan cannot be used to increase the benefits any employee would otherwise receive under the plan. Forfeitures must be used instead to reduce employer contributions.

B. SETTING UP A QUALIFIED PLAN

There are two basic steps in setting up a qualified plan. First, an employer must adopt a written plan. The plan assets must then be invested. The employer is responsible for setting up and maintaining the plan. If someone is self-employed, it is not necessary to have other employees to sponsor and set up a qualified plan.

1. Set-up Deadline

To take a deduction for contributions for a tax year, a plan must be set up (adopted) by the last day of that year (December 31 for calendar year employers).

2. Credit for Startup Costs

An employer may be able to claim a tax credit for part of the ordinary and necessary costs of starting up a qualified plan for the year that it first became effective.

3. Adopting a Written Plan

A written plan must be adopted. The plan can be an IRS-approved master or prototype plan offered by a sponsoring organization, or it can be an individually designed plan.

To qualify, the plan that is set up must be in writing and must be communicated to all employees. The plan's provisions must be stated in the plan. It is not sufficient for the plan to merely refer to a requirement of the Internal Revenue Code.

Most qualified plans follow a standard form of plan (a master or prototype plan) approved by the IRS. Master and prototype plans are plans made available by plan providers for adoption by employers (including self-employed individuals). Under a master plan, a single trust or custodial account is established, as part of the plan, for the joint use of all adopting employers. Under a prototype plan, a separate trust or custodial account is established for each employer.

4. Individually Designed Plans

Businesses may prefer to set up an individually designed plan to meet specific needs. Although advance IRS approval is not required, the employer can apply for approval by paying a fee and requesting a determination letter.

C. MAKING CONTRIBUTIONS

In setting up a qualified plan, an employer arranges how the plan's funds will be used to build its assets. The following are some of the options:

- ☐ An employer can establish a trust or custodial account to invest the funds;
- ☐ The employer, the trust, or the custodial account can buy an annuity contract from an insurance company. Life insurance can be included only if it is incidental to the retirement benefits;

- ❑ The employer, the trust, or the custodial account can buy face-amount certificates from an insurance company. These certificates are treated like annuity contracts;
- ❑ The employer can set up a trust by a legal instrument (written document); or
- ❑ The employer can set up a custodial account with a bank, savings and loan association, credit union, or other person who can act as the plan trustee. Employers do not need a trust or custodial account, although they can have one, to invest the plan's funds in annuity contracts or face-amount certificates. If anyone other than a trustee holds them, however, the contracts or certificates must state they are not transferable.

1. Minimum Funding Requirement

In general, if a plan is a money purchase pension plan or a defined benefit plan, the employer must actually pay enough into the plan to satisfy the minimum funding standard for each year. Determining the amount needed to satisfy the minimum funding standard for a defined benefit plan is complicated. The amount is based on what should be contributed under the plan formula using actuarial assumptions and formulas.

2. Quarterly Installments of Required Contributions

If a plan is a defined benefit plan subject to the minimum funding requirements, employers must make quarterly installment payments of the required contributions. If they do not pay the full installments timely, they may have to pay interest on any underpayment for the period of the underpayment.

The due dates for the installments are 15 days after the end of each quarter. For a calendar-year plan, the installments are due April 15, July 15, October 15, and January 15 (of the following year). Each quarterly installment must be 25% of the required annual payment.

Additional contributions required to satisfy the minimum funding requirement for a plan year will be considered timely if made by 8½ months after the end of that year.

3. Employee / Self-Employed Individual Contributions

A qualified plan is generally funded by employer contributions. However, employees participating in the plan may be permitted to make contributions. Eligible employees can make deductible contributions for a tax year up to the due date of their return (plus extensions) for that year.

Self-employed individuals can make contributions on behalf of themselves only if they have net earnings (compensation) from self-employment in the trade or business for which the plan was set up. Their net earnings must be from their personal services, not from their investments. If the individual has a net loss from self-employment, they cannot make contributions for themselves for the year, even if they can contribute for common-law employees based on their compensation.

4. When Contributions Are Considered Made

Employers generally apply their plan contributions to the year in which they make them. But employers can apply them to the previous year if all the following requirements are met:

- ☐ Contributions are made by the due date of their tax return for the previous year (plus extensions);
- ☐ The plan was established by the end of the previous year;
- ☐ The plan treats the contributions as though it had received them on the last day of the previous year; or
- ☐ The employer does either of the following:
 - They specify in writing to the plan administrator or trustee that the contributions apply to the previous year; or
 - They deduct the contributions on their tax return for the previous year.

An employer's promissory note made out to the plan is not a payment that qualifies for the deduction.

D. CONTRIBUTIONS LIMITS

There are certain limits on the contributions and other annual additions employers can make each year for plan participants. There are also limits on the amount employers can deduct.

A plan must provide that contributions or benefits cannot exceed certain limits. The limits differ depending on whether a plan is a defined contribution plan or a defined benefit plan. These limits are published annually by the IRS. Excess annual additions are the amounts contributed to a defined contribution plan that are more than the limits discussed previously. A plan can correct excess annual additions caused by any of the following actions:

- ☐ A reasonable error in estimating a participant's compensation;
- ☐ A reasonable error in determining the elective deferrals permitted; or
- ☐ Forfeitures allocated to participants' accounts.

A plan can provide for the correction of excess annual additions in several ways, including reallocating the excess to other participants in the plan to the extent of their unused limits for the year. The employer can also carry over the excess in a separate account and allocate (and reallocate) it to participants' accounts in the following year (or years) before making any contributions for that year.

The return of employee after-tax contributions or the distribution of elective deferrals to correct excess annual additions is considered a corrective payment rather than a distribution of accrued benefits. The penalties for early distributions and excess distributions do not apply. In addition, these disbursements are not wages reportable on Form W-2.

Employee participants may be permitted to make nondeductible contributions to a plan in addition to their employer's contributions. Even though these employee contributions are not deductible, the earnings on them are tax free until distributed in later years.

E. EMPLOYER DEDUCTION

Employers can usually deduct, subject to limits, contributions they make to a qualified plan, including those made for their own retirement. The contributions (and earnings and gains on them) are generally tax free until distributed by the plan. The deduction limit for an employer's contributions to a qualified plan depends on the kind of plan they have.

1. Defined Contribution Plans

The deduction for contributions to a defined contribution plan (profit-sharing plan or money purchase pension plan) cannot be more than 25% of the compensation paid (or accrued) during the year to an employer's eligible employees participating in the plan. If the employer is self-employed, they must reduce this limit in figuring the deduction for contributions they make for their own account.

When figuring the deduction limit, the following rules apply:

- ❑ Elective deferrals (discussed later) are not subject to the limit;
- ❑ Compensation includes elective deferrals; and
- ❑ The maximum compensation that can be taken into account for each employee is \$200,000 (indexed) (\$230,000 for 2008; \$245,000 for 2009).

2. Defined Benefit Plans

The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Consequently, an actuary must figure an employer's deduction limit.

In figuring the deduction for contributions, employers cannot take into account any contributions or benefits that are more than the limits discussed earlier. However, an employer's deduction for contributions to a defined benefit plan can be as much as the plan's unfunded current liability.

3. Deduction Limit for Multiple Plans

If an employer contributes to both a defined contribution plan and a defined benefit plan and at least one employee is covered by both plans, the employer's deduction for those contributions is limited. Their deduction cannot be more than the greater of the following amounts:

- ❑ 25% of the compensation paid (or accrued) during the year to eligible employees participating in the plan. If the employer is self-employed, they must reduce this 25% limit in figuring the deduction for contributions they make for their own account; or
- ❑ Actual contributions to the defined benefit plans, but not more than the amount needed to meet the year's minimum funding standard for any of these plans.

This limit does not apply if contributions to the defined contribution plan consist only of elective deferrals. For this rule, a SEP is treated as a separate profit-sharing (defined contribution) plan.

4. Deduction Limit for Self-Employed Individuals

If an employer makes contributions for themselves, they need to make a special computation to figure their maximum deduction for these contributions. Compensation is their net earnings from self-employment. This definition takes into account both the following items:

- ❑ The deduction for one-half of their self-employment tax; and
- ❑ The deduction for contributions on their behalf to the plan.

The deduction for an individual's own contributions and their net earnings depend on each other. For this reason, a self-employed person determines the deduction for their own contributions indirectly by reducing the contribution rate called for in their plan. The deduction limit for multiple plans (discussed earlier) also applies to contributions an employer makes on their own behalf.

5. Carryover of Excess Contributions

If an employer contributes more to the plans than they can deduct for the year, they can carry over and deduct the difference in later years, combined with their contributions for those years. The employer's combined deduction in a later year is limited to 25% of the participating employees' compensation for that year. For purposes of this limit, a SEP is treated as a profit-sharing (defined contribution) plan. However, this percentage limit must be reduced to figure their maximum deduction for contributions an employer makes for himself. The amount an employer carries over and deducts may be subject to the excise tax, below.

6. Excise Tax for Nondeductible (Excess) Contributions

If an employer contributes more than their deduction limit to a retirement plan, they have made nondeductible contributions and may be liable for an excise tax. In general, a 10% excise tax applies to nondeductible contributions made to qualified pension and profit-sharing plans and to SEPs.

There is a special rule for self-employed individuals. The 10% excise tax does not apply to any contribution made to meet the minimum funding requirements in a money purchase pension plan or a defined benefit plan. Even if that contribution is more than the self-employed person's earned income from the trade or business for which the plan is set up, the difference is not subject to this excise tax.

7. Exceptions

If an employer maintains a defined benefit plan, there are some exceptions that may enable them to choose not to take certain nondeductible contributions into account when figuring the 10% excise tax. For example, if contributions to one or more defined contribution plans are not deductible only because they are more than the combined plan deduction limit, the 10% excise tax does not apply to the extent the difference is not more than the greater of the following amounts: (a) 6% of the participants' compensation (including elective deferrals) for the year, and (b) the sum of employer matching contributions and the elective deferrals to a 401(k) plan.

Likewise, in calculating the 10% excise tax, an employer can choose not to take into account as nondeductible contributions for any year contributions to a defined benefit plan that are not more than the full funding limit figured without considering the current liability limit.

F. ELECTIVE DEFERRALS (401K PLANS)

An employer's qualified plan can include a cash or deferred arrangement under which participants can choose to have their employer contribute part of their before-tax compensation to the plan rather than receive the compensation in cash. A plan with this type of arrangement is popularly known as a "401(k) plan." (A self-employed individual participating in the plan can contribute part of their before-tax net earnings from the business.) This contribution is called an "elective deferral" because participants choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them.

In general, a qualified plan can include a cash or deferred arrangement only if the qualified plan is one of the following plans:

- ❑ A profit-sharing plan; or
- ❑ A money purchase pension plan in existence on June 27, 1974, that included a salary reduction arrangement on that date.

1. Automatic Enrollment

A 401(k) plan can have an automatic enrollment feature. Under this feature, an employer can automatically reduce an employee's pay by a fixed percentage and contribute that amount to the 401(k) plan on his or her behalf unless the employee affirmatively chooses not to have his or her pay reduced or chooses to have it reduced by a different percentage. These contributions qualify as elective deferrals.

2. Partnership

A partnership can have a 401(k) plan.

3. Restriction on Conditions of Participation

The plan cannot require, as a condition of participation, that an employee complete more than 1 year of service.

4. Matching Contributions

If the plan permits, employers can make matching contributions for an employee who makes an elective deferral to their 401(k) plan. For example, the plan might provide that the employer will contribute 50 cents for each dollar their participating employees choose to defer under the 401(k) plan.

5. Non-Elective Contributions

Employers can, under a qualified 401(k) plan, also make contributions (other than matching contributions) for their participating employees without giving them the choice to take cash instead.

6. Employee Compensation Limit

No more than \$230,000 for 2008 (\$245,000 for 2009) of the employee's compensation can be taken into account when figuring contributions.

G. DISTRIBUTIONS

Amounts paid to plan participants from a qualified plan are called distributions. Distributions may be non-periodic, such as lump-sum distributions, or periodic, such as annuity payments. Also, certain loans may be treated as distributions.

1. Required Distributions

A qualified plan must provide that each participant will either:

- ☐ Receive his or her entire interest (benefits) in the plan by the required beginning date (defined later), or
- ☐ Begin receiving regular periodic distributions by the required beginning date in annual amounts calculated to distribute the participant's entire interest (benefits) over his or her life expectancy or over the joint life expectancy of the participant and the designated beneficiary (or over a shorter period).

These distribution rules apply individually to each qualified plan. Employers cannot satisfy the requirement for one plan by taking a distribution from another. The plan must provide that these rules override any inconsistent distribution options previously offered.

2. Minimum Distributions

If the account balance of a qualified plan participant is to be distributed (other than as an annuity), the plan administrator must figure the minimum amount required to be distributed each distribution calendar year. This minimum is figured by dividing the account balance by the applicable life expectancy.

Minimum distributions must also meet the minimum distribution incidental benefit requirement. This requirement ensures the plan is used primarily to provide retirement benefits to the employee. After the employee's death, only "incidental" benefits are expected to remain for distribution to the employee's beneficiary (or beneficiaries).

3. Required Beginning Date

Generally, each participant must receive his or her entire benefits in the plan or begin to receive periodic distributions of benefits from the plan by the required beginning date.

A participant must begin to receive distributions from his or her qualified retirement plan by April 1 of the first year after the later of the following years: (a) the calendar year in which he or she reaches age 70½; or (b) the calendar year in which he or she retires.

However, the plan may require the participant to begin receiving distributions by April 1 of the year after the participant reaches age 70½ even if the participant has not retired.

If the participant is a 5% owner of the employer maintaining the plan or if the distribution is from a traditional or SIMPLE IRA, the participant must begin receiving distributions by April 1 of the first year after the calendar year in which the participant reached age 70½.

Note: The Worker, Retiree, and Employer Recovery Act of 2008 (Act) was signed into law by the President on December 23, 2008. The Act waives 2009 required minimum distributions (RMDs) from IRAs, 401(k), profit-sharing money purchase pension, 403(b), and certain 457 retirement plans. The Act does not waive any 2008 RMDs due by April 1, 2009.

4. Distributions After the Starting Year

The distribution required to be made by April 1 is treated as a distribution for the starting year. After the starting year, the participant must receive the required distribution for each year by December 31 of that year. If no distribution is made in the starting year, required distributions for 2 years must be made in the next year (one by April 1 and one by December 31).

5. Distributions From 401(k) Plans

Generally, distributions cannot be made until one of the following occurs:

- ☐ The employee retires, dies, becomes disabled, or otherwise severs employment;
- ☐ The plan ends and no other defined contribution plan is established or continued;
or
- ☐ In the case of a 401(k) plan that is part of a profit-sharing plan, the employee reaches age 59½ or suffers financial hardship.

Even in such cases, certain distributions may be subject to the tax on early distributions.

H. TAX TREATMENT OF DISTRIBUTIONS

Distributions from a qualified plan minus a prorated part of any cost basis are subject to income tax in the year they are distributed. Since most recipients have no cost basis, a distribution is generally fully taxable.

The tax treatment of distributions depends on whether they are made periodically over several years or life (periodic distributions) or are non-periodic distributions.

1. Rollover

The recipient of an eligible rollover distribution from a qualified plan can defer the tax on it by rolling it over into a traditional IRA or another eligible retirement plan. However, it may be subject to withholding.

2. Eligible Rollover Distribution

This is a distribution of all or any part of an employee's balance in a qualified retirement plan that is not any of the following:

- ❑ A required minimum distribution;
- ❑ Any of a series of substantially equal payments made at least once a year over any of the following periods;
 - The employee's life or life expectancy;
 - The joint lives or life expectancies of the employee and beneficiary; or
 - A period of 10 years or longer.
- ❑ A hardship distribution;
- ❑ The portion of a distribution that represents the return of an employee's nondeductible contributions to the plan;
- ❑ A corrective distribution of excess contributions or deferrals under a 401(k) plan and any income allocable to the excess, or of excess annual additions and any allocable gains;
- ❑ Loans treated as distributions;
- ❑ Dividends on employer securities; or
- ❑ The cost of life insurance coverage.

A distribution of the employee's nondeductible contributions may qualify as a rollover distribution. The transfer must be made either (1) through a direct rollover to a defined contribution plan that separately accounts for the taxable and nontaxable parts of the rollover or (2) through a rollover to a traditional IRA.

3. Withholding Requirement

If, during a year, a qualified plan pays to a participant one or more eligible rollover distributions that are reasonably expected to total \$200 or more, the payor must withhold 20% of each distribution for federal income tax.

If, instead of having the distribution paid to him or her, the participant chooses to have the plan pay it directly to an IRA or another eligible retirement plan (a direct rollover), no withholding is required.

If the distribution is not an eligible rollover distribution, the 20% withholding requirement does not apply. Other withholding rules apply to distributions such as long-term periodic distributions and required distributions (periodic or non-periodic). However, the participant can still choose not to have tax withheld from these distributions. If the participant does not make this choice, the following withholding rules apply:

- ❑ For periodic distributions, withholding is based on their treatment as wages; and
- ❑ For non-periodic distributions, 10% of the taxable part is withheld.

4. Estimated Tax Payments

If no income tax is withheld or not enough tax is withheld, the recipient of a distribution may have to make estimated tax payments.

5. Tax on Early Distributions

If a distribution is made to an employee under the plan before he or she reaches age 59½, the employee may have to pay a 10% additional tax on the distribution. This tax applies to the amount received that the employee must include in income.

The 10% tax will not apply if distributions before age 59½ are made in any of the following circumstances:

- ❑ Made to a beneficiary (or to the estate of the employee) on or after the death of the employee;
- ❑ Made due to the employee having a qualifying disability;
- ❑ Made as part of a series of substantially equal periodic payments beginning after separation from service and made at least annually for the life or life expectancy of the employee or the joint lives or life expectancies of the employee and his or her designated beneficiary. (The payments under this exception, except in the case of death or disability, must continue for at least 5 years or until the employee reaches age 59½, whichever is the longer period);
- ❑ Made to an employee after separation from service if the separation occurred during or after the calendar year in which the employee reached age 55;
- ❑ Made to an alternate payee under a qualified domestic relations order (QDRO);
- ❑ Made to an employee for medical care up to the amount allowable as a medical expense deduction (determined without regard to whether the employee itemizes deductions);
- ❑ Timely made to reduce excess contributions under a 401(k) plan;

- ❑ Timely made to reduce excess employee or matching employer contributions (excess aggregate contributions);
- ❑ Timely made to reduce excess elective deferrals; or
- ❑ Made because of an IRS levy on the plan.

6. Tax on Excess Benefits

If an individual is or has been a 5% owner of the business maintaining the plan, amounts they receive at any age that are more than the benefits provided for them under the plan formula are subject to an additional tax. This tax also applies to amounts received by the person's successor. The tax is 10% of the excess benefit includible in income.

An individual is a 5% owner if they meet either of the following conditions at any time during the 5 plan years immediately before the plan year that ends within the tax year they receive the distribution:

- ❑ The individual owns more than 5% of the capital or profits interest in the employer; or
- ❑ The individual owns or is considered to own more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer.

A 20% or 50% excise tax is generally imposed on the cash and fair market value of other property an employer receives directly or indirectly from a qualified plan.

An employer or the plan will have to pay an excise tax if both the following occur:

- ❑ A defined benefit plan or money purchase pension plan is amended to provide for a significant reduction in the rate of future benefit accrual; and
- ❑ The plan administrator fails to notify the affected individuals and the employee organizations representing them of the reduction in writing. Affected individuals are the participants and alternate payees whose rate of benefit accrual under the plan may reasonably be expected to be significantly reduced by the amendment.

A plan amendment that eliminates or reduces any early retirement benefit or retirement-type subsidy reduces the rate of future benefit accrual.

The notice must be written in a manner calculated to be understood by the average plan participant and must provide enough information to allow each individual to understand the effect of the plan amendment. It must be provided within a reasonable time before the amendment takes effect.

The tax is \$100 per participant or alternate payee for each day the notice is late. It is imposed on the employer, or, in the case of a multi-employer plan, on the plan. There are certain exceptions to, and limitations on, the tax. The tax does not apply in any of the following situations:

- ❑ The person liable for the tax was unaware of the failure and exercised reasonable diligence to meet the notice requirements.
- ❑ The person liable for the tax exercised reasonable diligence to meet the notice requirements and provided the notice within 30 days starting on the first date the person knew or should have known that the failure to provide notice existed.
- ❑ If the person liable for the tax exercised reasonable diligence to meet the notice requirement, the tax cannot be more than \$500,000 during the tax year. The tax can also be waived to the extent it would be excessive or unfair if the failure is due to reasonable cause and not to willful neglect.

I. PROHIBITED TRANSACTIONS

Prohibited transactions are transactions between the plan and a disqualified person that are prohibited by law. A disqualified person who takes part in a prohibited transaction must pay a tax. Prohibited transactions generally include the following transactions:

- ❑ A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person;
- ❑ Any act of a fiduciary by which he or she deals with plan income or assets in his or her own interest;
- ❑ The receipt of consideration by a fiduciary for his or her own account from any party dealing with the plan in a transaction that involves plan income or assets; and
- ❑ Any of the following acts between the plan and a disqualified person:
 - Selling, exchanging, or leasing property;
 - Lending money or extending credit; or
 - Furnishing goods, services, or facilities.

Certain transactions are exempt from being treated as prohibited transactions. For example, a prohibited transaction does not take place if a disqualified person receives any benefit to which they are entitled as a plan participant or beneficiary. However, the benefit must be figured and paid under the same terms as for all other participants and beneficiaries.

1. Disqualified Persons

A person is a disqualified person if they are any of the following:

- ❑ A fiduciary of the plan;
- ❑ A person providing services to the plan;
- ❑ An employer, any of whose employees are covered by the plan;

- ❑ An employee organization, any of whose members are covered by the plan.
- ❑ Any direct or indirect owner of 50% or more of any of the following:
 - The combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock of a corporation that is an employer or employee organization described above;
 - The capital interest or profits interest of a partnership that is an employer or employee organization described above;
 - The beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described above;
 - A member of the family of any individual described above. (A member of a family is the spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.);
- ❑ A corporation, partnership, trust, or estate of which (or in which) any direct or indirect owner described in above holds 50% or more of any of the following:
 - The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;
 - The capital interest or profits interest of a partnership;
 - The beneficial interest of a trust or estate;
 - An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10% or more shareholder, or highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described above;
 - A 10% or more (in capital or profits) partner or joint venturer of a person described above; or
 - Any disqualified person, as described above, who is a disqualified person with respect to any plan to which a § 501(c)(22) trust is permitted to make payments under § 4223 of ERISA.

2. Tax on Prohibited Transactions

The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed.

Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

The amount involved in a prohibited transaction is the greater of the following amounts: (a) the money and fair market value of any property given; or (b) the money and fair market value of any property received. If services are performed, the amount involved is any excess compensation given or received.

3. Taxable Period

The taxable period starts on the transaction date and ends on the earliest of the following days:

- ❑ The day the IRS mails a notice of deficiency for the tax;
- ❑ The day the IRS assesses the tax; or
- ❑ The day the correction of the transaction is completed.

4. Correcting a Prohibited Transaction

If someone is a disqualified person who participated in a prohibited transaction, they can avoid the 100% tax by correcting the transaction as soon as possible. Correcting the transaction means undoing it as much as possible without putting the plan in a worse financial position than if the person had acted under the highest fiduciary standards.

If the prohibited transaction is not corrected during the taxable period, the person usually has an additional 90 days after the day the IRS mails a notice of deficiency for the 100% tax to correct the transaction. This correction period (the taxable period plus the 90 days) can be extended if either the IRS grants reasonable time to correct the transaction or an appeal is made to the Tax Court.

If the transaction is corrected within this period, the IRS will abate, credit, or refund the 100% tax.

J. QUALIFICATION RULES

To qualify for the tax benefits available to qualified plans, a plan must meet certain requirements (qualification rules) of the tax law. Generally, the following qualification rules also apply to a SIMPLE 401(k) retirement plan. A SIMPLE 401(k) plan is, however, not subject to the top-heavy plan rules and nondiscrimination rules.

1. Plan Assets Must Not Be Diverted

The plan must make it impossible for its assets to be used for, or diverted to, purposes other than the benefit of employees and their beneficiaries. As a general rule, the assets cannot be diverted to the employer.

2. Non-Discrimination

Contributions or benefits must not discriminate. Under the plan, contributions or benefits to be provided must not discriminate in favor of highly compensated employees.

3. Contribution and Benefit Limits

Contributions and benefits must not be more than certain limits. The limits apply to the annual contributions and other additions to the account of a participant in a defined contribution plan and to the annual benefit payable to a participant in a defined benefit plan.

4. Vesting Standards

A plan must satisfy certain requirements regarding when benefits vest. A benefit is vested (a participant has a fixed right to it) when it becomes non-forfeitable. A benefit is non-forfeitable if it cannot be lost upon the happening, or failure to happen, of any event.

5. Participation

In general, an employee must be allowed to participate in the plan if he or she meets both the following requirements: (a) they have reached age 21; and (b) they have at least one year of service (two years if the plan is not a 401(k) plan and provides that after not more than two years of service the employee has a non-forfeitable right to all his or her accrued benefit). A plan cannot exclude an employee because he or she has reached a specified age.

6. Early Retirement

A plan can provide for payment of retirement benefits before the normal retirement age. If a plan offers an early retirement benefit, a participant who separates from service before satisfying the early retirement age requirement is entitled to that benefit if he or she meets both the following requirements:

- ❑ Satisfies the service requirement for the early retirement benefit; and
- ❑ Separates from service with a non-forfeitable right to an accrued benefit. The benefit, which may be actuarially reduced, is payable when the early retirement age requirement is met.

7. Survivor Benefits

Defined benefit and money purchase pension plans must provide automatic survivor benefits in both the following forms:

- ❑ A qualified joint and survivor annuity for a vested participant who does not die before the annuity starting date; and
- ❑ A qualified pre-retirement survivor annuity for a vested participant who dies before the annuity starting date and who has a surviving spouse.

The automatic survivor benefit also applies to any participant under a profit-sharing plan unless all the following conditions are met:

- ❑ The participant does not choose benefits in the form of a life annuity;

- ❑ The plan pays the full vested account balance to the participant's surviving spouse (or other beneficiary if the surviving spouse consents or if there is no surviving spouse) if the participant dies; and
- ❑ The plan is not a direct or indirect transferee of a plan that must provide automatic survivor benefits.

If survivor benefits are required for a spouse under a plan, he or she must consent to a loan that uses as security the accrued benefits in the plan. Each plan participant may be permitted to waive the joint and survivor annuity or the pre-retirement survivor annuity (or both), but only if the participant has the written consent of the spouse. The plan also must allow the participant to withdraw the waiver. The spouse's consent must be witnessed by a plan representative or notary public.

8. Waiver of Waiting Period

A plan may permit a participant to waive (with spousal consent) the 30-day minimum waiting period after a written explanation of the terms and conditions of a joint and survivor annuity is provided to each participant. The waiver is allowed only if the distribution begins more than 7 days after the written explanation is provided.

9. Involuntary Cash-Out of Benefits

A plan may provide for the immediate distribution of the participant's benefit under the plan if the present value of the benefit is not greater than \$5,000. However, the distribution cannot be made after the annuity starting date unless the participant and the spouse or surviving spouse of a participant who died (if automatic survivor benefits are required for a spouse under the plan) consents in writing to the distribution.

If the present value is greater than \$5,000, the plan must have the written consent of the participant and the spouse or surviving spouse (if automatic survivor benefits are required for a spouse under the plan) for any immediate distribution of the benefit. Benefits attributable to rollover contributions and earnings on them can be ignored in determining the present value of these benefits.

10. Consolidation, Merger or Transfer of Assets or Liabilities

A plan must provide that, in the case of any merger or consolidation with, or transfer of assets or liabilities to, any other plan, each participant would (if the plan then terminated) receive a benefit equal to or more than the benefit he or she would have been entitled to just before the merger, etc. (if the plan had then terminated).

A plan must provide that its benefits cannot be assigned or alienated. However, a loan from the plan (not from a third party) to a participant or beneficiary is not treated as an assignment or alienation if the loan is secured by the participant's accrued non-forfeitable benefit and is exempt from the tax on prohibited transactions under section 4975(d)(1) or would be exempt if the participant were a disqualified person. A disqualified person is defined earlier under Prohibited Transactions, above.

11. No Benefit Reduction for Social Security Increases

A plan must not permit a benefit reduction for a post-separation increase in the social security benefit level or wage base for any participant or beneficiary who is receiving benefits under your plan, or who is separated from service and has non-forfeitable rights to benefits. This rule also applies to plans supplementing the benefits provided by other federal or state laws.

12. Top-Heavy Plan Requirements

A top-heavy plan is one that mainly favors partners, sole proprietors, and other key employees. A plan is top heavy for any plan year for which the total value of accrued benefits or account balances of key employees is more than 60% of the total value of accrued benefits or account balances of all employees. Additional requirements apply to a top-heavy plan primarily to provide minimum benefits or contributions for non-key employees covered by the plan.

Most qualified plans, whether or not top heavy, must contain provisions that meet the top-heavy requirements and will take effect in plan years in which the plans are top heavy. These qualification requirements for top-heavy plans are explained in § 416 and its regulations. The top-heavy plan requirements do not apply to SIMPLE 401(k) plans or to safe harbor 401(k) plans that consist solely of safe harbor contributions.

CHAPTER 11 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following statements about SIMPLE plans is not correct:
 - a) this type of retirement plan is intended for large employers
 - b) this type of retirement plan is intended for small employers
 - c) employees can put money away for retirement with pre-tax dollars
 - d) employers may make matching contributions to an employee's SIMPLE plan
2. A SEP-IRA is owned and controlled by the employer.
 - a) true
 - b) false
3. There is no cap on the amount of contributions made to employees' SEP-IRA plans that an employer can deduct.
 - a) true
 - b) false
4. To be eligible to establish a SIMPLE plan, an employer must have 100 or fewer employees.
 - a) true
 - b) false
5. The general rule requires an employer to establish a SIMPLE IRA plan:
 - a) effective on any date between January 1 and October 1
 - b) effective on any date of the year
 - c) effective on any date between January 1 and March 1
 - d) effective on any date between March 1 and July 1
6. SIMPLE IRA contributions are subject to federal income tax withholding.
 - a) true
 - b) false

7. A qualified retirement plan cannot include coverage for a self-employed individual.
- a) true
 - b) false
8. Employers can usually deduct contributions made to a qualified retirement plan except for those made for their own retirement.
- a) true
 - b) false
9. When can distributions from a qualified employer-sponsored 401(k) be made:
- a) the employee dies or retires
 - b) the plan ends
 - c) the employee either reaches age 59½ or suffers financial hardship
 - d) all of the above
10. A distribution from a qualified plan is generally fully taxable.
- a) true
 - b) false

CHAPTER 11 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** Only employers with 100 or fewer employees are eligible to establish SIMPLE plans.

B: Incorrect. These plans are designed for small employers, and those with more than 100 employees are not eligible.

C: Incorrect. Employees can elect to have a salary reduction fund these plans with pre-tax dollars.

D: Incorrect. Employers can make elective matching contributions to their employee's plans.

(See page 11-1 of the course material.)

2. A: True is incorrect. The employee, not the employer, controls and owns the account.

B: False is correct. A SEP-IRA is owned and controlled by the employee, and the employer makes contributions to the financial institution where the IRA is maintained.

(See page 11-2 of the course material.)

3. A: True is incorrect. A limit is established annually by federal regulations.

B: False is correct. Federal law annually establishes a cap on how much an employer can deduct for their contributions for plan participants. In 2008, for example, it was the lesser of the employer's actual contributions or 25% of the compensation (limited to \$230,000 per plan participant) paid to the participants during the year from the business that has the plan, not to exceed \$46,000 per participant.

(See page 11-5 of the course material.)

4. **A: True is correct.** To be eligible, the employer must have had 100 or fewer employees, each of whom received \$5,000 or more in compensation during the preceding year. Under this rule, employers must take into account all employees employed at any time during the calendar year regardless of whether they are eligible to participate.

B: False is incorrect. Eligibility requirements include a maximum number of employees.

(See page 11-9 of the course material.)

5. **A: Correct.** This is true provided the employer did not already maintain a SIMPLE IRA. In addition, there is an exception to this general rule for new employers.

B: Incorrect. Unless it is a new employer, such plans must generally be enacted by October 1.

C: Incorrect. The period is much longer.

D: Incorrect. The period runs from January 1 through October 1.

(See page 11-11 of the course material.)

6. A: True is incorrect. SIMPLE IRA contributions are not subject to federal income tax withholding.

B: False is correct. Although such contributions are not subject to federal income tax withholding, salary reduction contributions are subject to social security, Medicare and federal unemployment taxes.

(See page 11-14 of the course material.)

7. A: True is incorrect. A sole proprietor or partnership can set up a qualified plan.

B: False is correct. A qualified retirement plan can include coverage for self-employed individuals. Under such circumstances, the self-employed individual is treated as both an employer and an employee.

(See page 11-15 of the course material.)

8. A: True is incorrect. Deductions can include contributions made for the employer's own retirement.

B: False is correct. Employers can usually deduct, subject to limits, contributions they make to a qualified plan, including those made for their own retirement. The contributions are generally tax free until distributed by the plan.

(See page 11-20 of the course material.)

9. A: Incorrect. Either of these events triggers the right to take distributions, although early retirement might entail taxes or penalties on withdrawal. However, this is not the best answer.

B: Incorrect. If the plan ends then the employee or former employee is entitled to take distributions. However, this is not the best answer.

C: Incorrect. In such cases, the employee can take distributions although they may be subject to tax. This, however, is not the best answer.

D: Correct. In any of the given situations, an individual may take distributions. Remember, however, that even though distributions may be taken, some of these could be subject to tax for early distribution.

(See page 11-24 of the course material.)

10. **A: True is correct.** Distributions from a qualified plan minus a prorated part of any cost basis are subject to income tax in the year they are distributed. Since most recipients have no cost basis, a distribution is generally fully taxable.

B: False is incorrect. The tax treatment of distributions depends on whether they are made periodically over several years or life (periodic distributions) or are non-periodic distributions.

(See pages 11-24 to 11-25 of the course material.)

Chapter 12: Individual Retirement Arrangements (IRAs)

An individual retirement arrangement (IRA) is a personal savings plan that gives individual taxpayers tax advantages for setting aside money for retirement. Two tax advantages of an IRA are that:

- ❑ Contributions made to an IRA may be fully or partially deductible, depending on the type of IRA and the taxpayers individual circumstances; and
- ❑ Generally, amounts in a taxpayer's IRA (including earnings and gains) are not taxed until distributed. In some cases, amounts are not taxed at all if distributed according to the rules.

I. Traditional IRA

This section discusses the original IRA. In this chapter the original IRA (sometimes called an ordinary or regular IRA) is referred to as a "traditional IRA."

A. ELIGIBILITY REQUIREMENTS

An individual can set up and make contributions to a traditional IRA if:

- ❑ The individual (or, if they file a joint return, their spouse) received taxable compensation during the year; and
- ❑ The individual was not age 70½ by the end of the year.

Individuals can have a traditional IRA whether or not they are covered by any other retirement plan. However, individuals may not be able to deduct all of their contributions if they or their spouse is covered by an employer retirement plan.

Table 12-1. How Are a Traditional IRA and a Roth IRA Different?

This table shows the differences between traditional and Roth IRAs. Answers in the middle column apply to traditional IRAs. Answers in the right column apply to Roth IRAs.

Question	Traditional IRA	Roth IRA
Age limits to set up and contribute to an IRA	Individual must not have reached age 70½ by the end of the year	Can be established at any age
Earnings and contribution limits	No upper limit on how much a taxpayer can earn and still contribute; contribution limits determined annually	Some limits based on income, filing status and whether taxpayer contributes to another IRA
Deductibility of Contributions	Taxpayers may be able to deduct contributions to IRA depending on income, filing status, and whether they are covered by a retirement plan at work or receive social security benefits	Contributions to Roth IRA are never deductible
Filing Requirement for Contributions	No filing required unless taxpayer made nondeductible contributions to traditional IRA (in which case Form 8606 must be filed)	No filing required for contributions to Roth IRA
Mandatory distributions	Taxpayers must begin receiving required minimum distributions by April 1 of the year following the year they reach age 70½*	Owners of Roth IRA not required to take distributions regardless of age
Taxation of Distributions	Distributions from an ordinary IRA are taxed as ordinary income, but if taxpayer made nondeductible contributions, not all of distribution is taxable	Distributions from Roth IRA are not taxed as long as owner meets certain criteria
Reporting of Distributions	No reporting requirements unless taxpayers ever made nondeductible contributions to traditional IRA (then must file Form 8606)	Owners must file Form 8606 if they receive distributions from a Roth IRA (other than a rollover, characterization, certain qualified distributions or a return of certain contributions)

If both the individual and their spouse have compensation and are under age 70½, each can set up an IRA, but cannot both participate in the same IRA.

***Note:** The Worker, Retiree, and Employer Recovery Act of 2008 (Act) was signed into law by the President on December 23, 2008. The Act waives 2009 required minimum distributions (RMDs) from IRAs, 401(k), profit-sharing money purchase pension, 403(b), and certain 457 retirement plans. The Act does not waive any 2008 RMDs due by April 1, 2009.

B. COMPENSATION

Generally, compensation is what an individual earns from working, i.e. wages, salaries, tips, professional fees and other amounts received for providing services. For self-employed individuals, compensation is the net earnings from the person's trade or business (provided their personal services are a material income-producing factor) reduced by the total of:

- ❑ The deduction for contributions made on the individual's behalf to retirement plans; and
- ❑ The deduction allowed for one-half of self-employment taxes.

1. Self-Employment Income

When an individual has both self-employment income and salaries and wages, their compensation includes *both* amounts. If an individual has a net loss from self-employment, they may not subtract the loss from their salaries or wages when figuring their total compensation.

2. Alimony and Separate Maintenance

For IRA purposes, compensation includes any taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance.

Table12- 2. Compensation for Purposes of an IRA

Compensation includes:	Compensation does NOT include:
<ul style="list-style-type: none">• wages, salaries, etc.• commissions• self-employment income• alimony and separate maintenance	<ul style="list-style-type: none">• earnings and profits from property• interest and dividend income• pension or annuity income• deferred compensation• income from certain partnerships¹

C. TYPES OF TRADITIONAL INDIVIDUAL RETIREMENT ARRANGEMENTS

A traditional IRA can be an individual retirement account or annuity. It can be part of either a simplified employee pension (SEP) or an employer or employee association trust account.

1. Individual Retirement Account

An individual retirement account is a trust or custodial account set up in the United States for the exclusive benefit of one person or their beneficiaries. The account is created by a written document. The document must show that the account meets all of the following requirements:

¹ Income from a partnership for which the individual does not provide services that are a material income-producing factor.

- ❑ The trustee or custodian must be a bank, a federally insured credit union, a savings and loan association, or an entity approved by the IRS to act as trustee or custodian;
- ❑ The trustee or custodian generally cannot accept contributions of more than \$5,000 (\$6,000 if the individual is 50 or older in 2008 and 2009). However, rollover contributions and employer contributions to a simplified employee pension (SEP), can be more than this amount;
- ❑ Contributions, except for rollover contributions, must be in cash;
- ❑ The investor must have a non-forfeitable right to the amount at all times;
- ❑ Money in the account cannot be used to buy a life insurance policy;
- ❑ Assets in the account cannot be combined with other property, except in a common trust fund or common investment fund; and
- ❑ The individual must start receiving distributions by April 1 of the year following the year in which they reach age 70½.

2. Individual Retirement Annuity

A person can set up an individual retirement annuity by purchasing an annuity contract or an endowment contract from a life insurance company. An individual retirement annuity must be issued in the investor's name as the owner, and either they or their beneficiaries who survive are the only ones who can receive the benefits or payments.

An individual retirement annuity must meet **all** of the following requirements:

- ❑ The investor's entire interest in the contract must be non-forfeitable;
- ❑ The contract must provide that the investor cannot transfer any portion of it to any person other than the issuer;
- ❑ There must be flexible premiums so that if the investor's compensation changes, their payment can also change. This provision applies to contracts issued after November 6, 1978;
- ❑ The contract must provide that contributions cannot be more than \$5,000 (\$6,000 if 50 or older in 2008 and 2009), and that the investor must use any refunded premiums to pay for future premiums or to buy more benefits before the end of the calendar year after the year in which they receive the refund; and
- ❑ Distributions must begin by April 1 of the year following the year in which the investor reaches age 70½.

3. Individual Retirement Bonds

The sale of individual retirement bonds issued by the federal government was suspended after April 30, 1982.

4. Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written arrangement that allows an investor's employer to make deductible contributions to a traditional IRA (a SEP-IRA) set up for the employee to receive such contributions. Generally, distributions from SEP IRAs are subject to the withdrawal and tax rules that apply to traditional IRAs.

D. CONTRIBUTION LIMITS

There are limits and other rules that affect the amount that can be contributed to a traditional IRA. The following are some rules to keep in mind:

- ❑ In most cases, each spouse figures his or her limit separately, using his or her own compensation. This is the rule even in states with community property laws;
- ❑ Brokers' commissions paid in connection with a traditional IRA are subject to the contribution limit;
- ❑ Trustees' administrative fees are not subject to the contribution limit; and
- ❑ Contributions on an individual's behalf to a traditional IRA reduce their limit for contributions to a Roth IRA.

1. General Limit

The most that can be contributed to a traditional IRA is the smaller of the following amounts:

- ❑ \$5,000 (\$6,000 if you are 50 or older in 2008 and 2009); or
- ❑ The individual's taxable compensation (defined above) for the year.

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions are nondeductible.

Examples.

George, who is 34 years old and single, earns \$24,000 in 2008. His IRA contributions for 2008 are limited to \$5,000.

Danny, an unmarried college student working part time, earns \$1,500 in 2008. His IRA contributions for 2008 are limited to \$1,500, the amount of his compensation.

2. More Than One IRA

If an individual has more than one traditional IRA, the limit applies to the total contributions made on the person's behalf to all of their traditional IRAs for the year.

3. Annuity or Endowment Contracts

If an individual invests in an annuity or endowment contract under an individual retirement annuity, no more than \$5,000 (\$6,000 if 50 or older) can be contributed toward its cost for the tax year, including the cost of life insurance coverage. If more than this amount is contributed, the annuity or endowment contract is disqualified.

4. Spousal IRA Limit

If an individual files a joint return and their taxable compensation is less than that of their spouse, the most that can be contributed for the year to their IRA is the smaller of the following two amounts:

- ❑ \$5,000 (\$6,000 if you are 50 or older), or
- ❑ The total compensation includable in the gross income of both the individual and their spouse for the year, reduced by the following two amounts: (a) their spouse's IRA contribution for the year to a traditional IRA; and (b) any contributions for the year to a Roth IRA on behalf of the person's spouse.

This means that the total combined contributions that can be made for the year to the individual's IRA and their spouse's IRA can be as much as \$10,000 (\$11,000 if only one of the two is 50 or older, or \$12,000 if both are 50 or older in 2008).

Note, however, that this traditional IRA limit is reduced by any contributions to a section 501(c)(18) plan (generally, a pension plan created before June 25, 1959, that is funded entirely by employee contributions).

Example.

Kristin, a full-time student with no taxable compensation, marries Carl during the year. Neither was 50 by the end of 2008. For the year, Carl has taxable compensation of \$30,000. He plans to contribute (and deduct) \$5,000 to a traditional IRA. If he and Kristin file a joint return, each can contribute \$5,000 to a traditional IRA. This is because Kristin, who has no compensation, can add Carl's compensation, reduced by the amount of his IRA contribution, ($\$30,000 - \$5,000 = \$25,000$) to her own compensation (-0-) to figure her maximum contribution to a traditional IRA. In her case, \$5,000 is her contribution limit, because \$5,000 is less than \$25,000 (her compensation for purposes of figuring her contribution limit).

Generally, an individual's filing status has no effect on the amount of allowable contributions to a traditional IRA. However, if during the year either the individual or their spouse was covered by a retirement plan at work, the individual's deduction may be reduced or eliminated, depending on their filing status and income.

Example.

Tom and Darcy are married and both are 53. They both work and each has a traditional IRA. Tom earned \$2,800 and Darcy earned \$48,000 in 2008. Because of the spousal IRA limit rule, even though Tom earned less than \$6,000, they can contribute up to \$6,000 to his IRA for 2008 if they file a joint return. They can contribute up to \$6,000 to Darcy's IRA. If they file separate returns, the amount that can be contributed to Tom's IRA is limited to \$2,800.

5. Less Than Maximum Contributions

A person who contributes less than the maximum allowed to their IRA one year may not contribute more than the applicable limit the following year or in any subsequent year to make up the difference.

6. More Than Maximum Contributions

If contributions to an individual's IRA for a year were more than the limit, the person can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year. However, a penalty or additional tax may apply.

E. TIMING OF CONTRIBUTIONS

Contributions can be made to a traditional IRA as soon as it has been established. Contributions must be in the form of money (cash, check, or money order). Property cannot be contributed. However, an individual may be able to transfer or roll over certain property from one retirement plan to another.

Contributions can be made to a traditional IRA for each year that the individual receives compensation and has not reached age 70½. For any year in which the individual does not work, contributions cannot be made to their IRA unless they receive alimony or file a joint return with a spouse who has compensation. Even if contributions cannot be made for the current year, the amounts contributed for years in which the individual did qualify can remain in their IRA. Contributions can resume for any years that the individual qualifies.

1. Due Date

Contributions can be made to a traditional IRA for a year at any time during the year or by the due date for filing their return for that year, not including extensions. For most people, this means, for example, that contributions for 2008 must be made by April 15, 2009, and contributions for 2009 must be made by April 15, 2010.

2. Age 70½ Rule

Contributions cannot be made to a traditional IRA for the year in which the individual reaches age 70½ or for any later year. An individual attains age 70½ on the date that is six calendar months after the 70th anniversary of their birth. If they were born on June 30, 1938, the 70th anniversary of their birth is June 30, 2008, and they attained age 70½ on December 30, 2008.

3. Designating Year of Contribution

If an amount is contributed to a traditional IRA between January 1 and April 15, the individual should tell their sponsor which year (the current year or the previous year) the contribution is for. If the individual does not tell the sponsor which year it is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).

F. DEDUCTIONS

Generally, an individual is entitled to deduct the lesser of:

- ❑ The contributions to their traditional IRA for the year; or
- ❑ The general limit (or the spousal IRA limit, if applicable) explained above.

However, if the individual or their spouse was covered by an employer retirement plan, they may not be able to deduct this amount.

1. Trustees' Fees

Trustees' administrative fees that are billed separately and paid in connection with a traditional IRA are not deductible as IRA contributions. However, they may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040).

2. Brokers' Commissions

These commissions are part of an IRA contribution and, as such, are deductible subject to the limits.

3. Full Deduction

If neither an individual nor their spouse was covered for any part of the year by an employer retirement plan, they can take a deduction for total contributions to one or more of their traditional IRAs of up to the lesser of:

- ❑ \$5,000 (\$6,000 if they are 50 or older); or
- ❑ 100% of their compensation.

This limit is reduced by any contributions made to a 501(c)(18) plan on the individual's behalf.

4. Spousal IRA

In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of:

- ❑ \$5,000 (\$6,000 if the spouse with the lower compensation is 50 or older), or
- ❑ The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts.
 - The IRA deduction for the year of the spouse with the greater compensation.
 - Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation.
 - Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

This limit is reduced by any contributions to a section 501(c)(18) plan on behalf of the spouse with the lesser compensation.

Note that if the individual in question was divorced or legally separated (and did not remarry) before the end of the year, they cannot deduct any contributions to their spouse's IRA. After a divorce or legal separation, an individual can deduct only the contributions to their own IRA. The individual's deductions are subject to the rules for single individuals.

5. Employer-Sponsored IRA

If an individual or their spouse was covered by an employer retirement plan at any time during the year for which contributions were made, their deduction may be further limited. Special rules apply to determine the tax years for which an individual was covered by an employer plan. These rules differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

a. Defined contribution plan. Generally, an individual is covered by a defined contribution plan for a tax year if amounts are contributed or allocated to their account for the plan year that ends with or within that tax year.

A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. In a defined contribution plan, the amount to be contributed to each participant's account is spelled out in the plan. The level of benefits actually provided to a participant depends on the total amount contributed to that participant's account and any earnings on those contributions. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Example 1.

Company A has a money purchase pension plan. Its plan year is from July 1 to June 30. The plan provides that contributions must be allocated as of June 30. Bob, an employee, leaves Company A on December 31, 2007. The contribution for the plan year ending on June 30, 2008, is made February 15, 2009. Because an amount is contributed to Bob's account for the plan year, Bob is covered by the plan for his 2008 tax year.

Example 2.

Mickey was covered by a profit-sharing plan and left the company on December 31, 2007. The plan year runs from July 1 to June 30. Under the terms of the plan, employer contributions do not have to be made, but if they are made, they are contributed to the plan before the due date for filing the company's tax return. Such contributions are allocated as of the last day of the plan year, and allocations are made to the accounts of individuals who have any service during the plan year. As of June 30, 2008, no contributions were made that were allocated to the June 30, 2008, plan year, and no forfeitures had been allocated within the plan year. In addition, as of that date, the company was not obligated to make a contribution for such plan year and it was impossible to determine whether or not a contribution would be made for the plan year. On December 31, 2008, the company decided to contribute to the plan for the plan year ending June 30, 2008. That contribution was made on February 15, 2009. Because an amount was allocated to Mickey's account as of June 30, 2008, Mickey is an active participant in the plan for his 2008 tax year but not for his 2009 tax year.

If an amount is allocated to an individual's account for a plan year, they are covered by that plan even if they have no vested interest in (legal right to) the account.

If an individual is eligible to participate in their employer's defined benefit plan for the plan year that ends within their tax year, they are covered by the plan. This rule applies even if the employee:

- ❑ Declined to participate in the plan;
- ❑ Did not make a required contribution; or
- ❑ Did not perform the minimum service required to accrue a benefit for the year.

b. Defined benefit plan. A defined benefit plan is any plan that is not a defined contribution plan. In a defined benefit plan, the level of benefits to be provided to each participant is spelled out in the plan. The plan administrator figures the amount needed to provide those benefits and those amounts are contributed to the plan. Defined benefit plans include pension plans and annuity plans.

Example.

Nick, an employee of Company B, is eligible to participate in Company B's defined benefit plan, which has a July 1 to June 30 plan year. Nick leaves Company B on December 31, 2007. Since Nick is eligible to participate in the plan for its year ending June 30, 2008, he is covered by the plan for his 2008 tax year.

If an individual accrues a benefit for a plan year, they are covered by that plan even if they have no vested interest in the accrual.

c. Situations in which individual is not covered. Unless an individual is covered by another employer plan, they are not covered by an employer plan if they are in one of the situations described below:

- ❑ **Social security or railroad retirement.** Coverage under social security or railroad retirement is not coverage under an employer retirement plan.
- ❑ **Benefits from previous employer's plan.** If an individual receives retirement benefits from a previous employer's plan, they are not covered by that plan.
- ❑ **Reservists.** If the only reason an individual participates in a plan is because they are a member of a reserve unit of the armed forces, they may not be covered by the plan. They are not covered by the plan if both of the following conditions are met:
 - The plan they participate in is established for its employees by: (a) the United States, (b) state or political subdivision of a state, or an instrumentality of either (a) or (b).
 - The individual did not serve more than 90 days on active duty during the year (not counting duty for training).
- ❑ **Volunteer firefighters.** If the only reason an individual participates in a plan is because they are a volunteer firefighter, they may not be covered by the plan. The individual is not covered by the plan if both of the following conditions are met:
 - The plan they participate in is established for its employees by: (a) the United States, (b) state or political subdivision of a state, or (c) an instrumentality of either (a) or (b) above; and
 - The individual's accrued retirement benefits at the beginning of the year will not provide more than \$1,800 per year at retirement.

6. Limit If Covered By Employer Plan

As discussed earlier, the deduction an individual can take for contributions made to their traditional IRA depends on whether they or their spouse was covered for any part of the year by an employer retirement plan. The allowable deduction is also affected by how much income the individual had and by their filing status. The deduction may also be affected by any social security benefits received.

If either the individual or their spouse was covered by an employer retirement plan, they may be entitled to only a partial (reduced) deduction or no deduction at all, depending on income and filing status. An individual's deduction begins to decrease (phase out) when their income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These amounts vary depending on an individual's filing status.

The amount of any reduction in the limit on an individual's IRA deduction (phaseout) depends on whether they or their spouse was covered by an employer retirement plan.

If an individual is covered by an employer retirement plan and the individual did not receive any social security retirement benefits, their IRA deduction may be reduced or eliminated depending on their filing status and modified AGI. For example, for 2008 – for individuals covered by a retirement plan at work – their IRA deduction will not be reduced unless their modified AGI is:

- ❑ More than \$53,000 but less than \$63,000 for a single individual (or head of household);
- ❑ More than \$85,000 but less than \$105,000 for a married couple filing a joint return (or a qualifying widow(er)); or
- ❑ Less than \$10,000 for a married individual filing a separate return.

The IRA deduction is completely eliminated above these modified AGIs. These amounts may be increased for years after 2008.

G. NONDEDUCTIBLE CONTRIBUTIONS

Although an individual's deduction for IRA contributions may be reduced or eliminated, contributions can be made to an IRA of up to the general limit or, if it applies, the spousal IRA limit. The difference between an individual's total permitted contributions and their IRA deduction, if any, is the individual's nondeductible contribution.

Example.

Tony is 29 years old and single. In 2008, he was covered by a retirement plan at work. His salary is \$57,312. His modified adjusted gross income (modified AGI) is \$65,000. Tony makes a \$5,000 IRA contribution for 2008. Because he was covered by a retirement plan and his modified AGI is above \$63,000, he cannot deduct his \$5,000 IRA contribution. He must designate this contribution as a nondeductible contribution by reporting it on Form 8606.

Individuals do not have to designate a contribution as nondeductible until they file their tax return. When it is filed, the individual can even designate otherwise deductible contributions as nondeductible contributions.

1. Failure to Report Nondeductible Contributions

If an individual fails to report nondeductible contributions, all of the contributions to their traditional IRA will be treated as deductible. All distributions from their IRA will be taxed unless the individual can show, with satisfactory evidence, that nondeductible contributions were made.

2. Penalty for Overstatement

If an individual overstates the amount of nondeductible contributions on their Form 8606 for any tax year, they must pay a penalty of \$100 for each overstatement, unless it was due to reasonable cause. There is also a \$50 penalty for failure to file Form 8606, unless the individual can provide that the failure was due to reasonable cause.

3. Tax on Earnings on Nondeductible Contributions

As long as contributions are within the contribution limits, none of the earnings or gains on contributions (deductible or nondeductible) will be taxed until they are distributed.

4. Cost Basis

Individuals will have a cost basis in their traditional IRA if they made any nondeductible contributions. Their cost basis is the sum of the nondeductible contributions to their IRA minus any withdrawals or distributions of nondeductible contributions. Commonly, distributions from a traditional IRA will include both taxable and nontaxable (cost basis) amounts.

H. INHERITED IRAS

Individuals who inherit a traditional IRA are referred to as a beneficiary. A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he or she dies. Beneficiaries of a traditional IRA must include in their gross income any taxable distributions they receive.

1. Inherited from Spouse

Individuals who inherit a traditional IRA from a spouse generally have the following three choices:

- ☐ Treat it as their own IRA by designating themselves as the account owner;
- ☐ Treat it as their own by rolling it over into their traditional IRA, or to the extent it is taxable, into a:
 - Qualified employer plan,
 - Qualified employee annuity plan (section 403(a) plan),
 - Tax-sheltered annuity plan (section 403(b) plan),
 - Deferred compensation plan of a state or local government (section 457 plan), or
- ☐ Treat themselves as the beneficiary rather than treating the IRA as their own.

2. Inherited From Someone Other Than Spouse

If an individual inherits a traditional IRA from anyone other than their deceased spouse, they cannot treat the inherited IRA as their own. This means that they cannot make any contributions to the IRA. It also means they cannot roll over any amounts into or out of the inherited IRA. However, they can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of the individual as beneficiary.

Like the original owner, the individual generally will not owe tax on the assets in the IRA until they receive distributions from it. They must begin receiving distributions from the IRA under the rules for distributions that apply to beneficiaries.

3. IRA with Basis

If an individual inherits a traditional IRA from a person who had a basis in the IRA because of nondeductible contributions, that basis remains with the IRA. With very few exceptions, the beneficiary cannot combine this basis with any basis they have in their own traditional IRA(s) or any basis in traditional IRA(s) they inherited from other decedents. If the individual takes distributions from both an inherited IRA and their own IRA, and each has basis, they must complete separate Forms 8606 to determine the taxable and nontaxable portions of those distributions.

4. Federal Estate Tax Deduction

A beneficiary may be able to claim a deduction for estate tax resulting from certain distributions from a traditional IRA. The beneficiary can deduct the estate tax paid on any part of a distribution that is income in respect of a decedent. He or she can take the deduction for the tax year the income is reported.

Any taxable part of a distribution that is not income in respect of a decedent is a payment the beneficiary must include in income. However, the beneficiary cannot take any estate tax deduction for this part.

A surviving spouse can roll over the distribution to another traditional IRA and avoid including it in income for the year received.

I. MOVING RETIREMENT PLAN ASSETS

Individuals can transfer, tax free, assets (money or property) from other retirement programs (including traditional IRAs) to a traditional IRA. The following types of transfers are permissible:

- ☐ Transfers from one trustee to another;
- ☐ Rollovers; and
- ☐ Transfers incident to a divorce.

1. Transfers to Roth IRAs

Under certain conditions, individuals can move assets from a traditional IRA to a Roth IRA.

2. Trustee-to-Trustee Transfer

A transfer of funds in an individual's traditional IRA from one trustee directly to another, either at the individual's request or at the trustee's request, is not a rollover. Because there is no distribution to the owner, the transfer is tax-free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers.

3. Rollovers

Generally, a rollover is a tax-free distribution to the owner of cash or other assets from one retirement plan that the owner contributes to another retirement plan. The contribution to the second retirement plan is called a “rollover contribution.” An amount rolled over tax free from one retirement plan to another is generally includible in income when it is distributed from the second plan. It is permissible to roll over amounts from the following plans to a traditional IRA:

- ❑ A traditional IRA;
- ❑ An employer's qualified retirement plan for its employees;
- ❑ A deferred compensation plan of a state or local government (section 457 plan);
or
- ❑ A tax-sheltered annuity plan (section 403 plan).

Individuals cannot deduct a rollover contribution. It must, however, be reported on the individual's tax return. In addition, a written explanation of rollover treatment must be given to the owner by the plan (other than an IRA) making the distribution.

Individuals may be able to roll over, tax free, a distribution from their traditional IRA into a qualified plan. These plans include the Federal Thrift Savings Fund (for federal employees), deferred compensation plans of state or local governments (section 457 plans), and tax-sheltered annuity plans (section 403(b) plans). The part of the distribution that an individual can roll over is the part that would otherwise be taxable (includible in their income). Qualified plans may, but are not required to, accept such rollovers.

If an individual rolls over a distribution from an IRA into an eligible retirement plan other than an IRA, the part of the distribution the individual rolls over is considered to come first from amounts other than after-tax contributions in any of their traditional IRAs. This means that the individual can roll over a distribution from an IRA with nontaxable income into a qualified plan if they have enough taxable income in their other IRAs to cover the nontaxable part. The effect of this is to make the amount in the individual's traditional IRAs that they can roll over to a qualified plan as large as possible.

4. Time Limit for Making a Rollover Contribution

Individuals generally must make the rollover contribution by the 60th day after the day they receive the distribution from their traditional IRA or their employer's plan. The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond the individual's reasonable control.

In the absence of a waiver, amounts not rolled over within the 60-day period do not qualify for tax-free rollover treatment. Individuals must treat them as a taxable distribution from either their IRA or their employer's plan. These amounts are taxable in the year distributed, even if the 60-day period expires in the next year. Individuals may also have to pay a 10% additional tax on early distributions.

Unless there is a waiver or an extension of the 60-day rollover period, any contribution an individual makes to their IRA more than 60 days after the distribution is a regular contribution, not a rollover contribution.

The 60-day rollover requirement is waived automatically only if all of the following apply:

- ❑ The financial institution receives the funds on the owner's behalf before the end of the 60-day rollover period;
- ❑ The owner followed all the procedures set by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan);
- ❑ The funds are not deposited into an eligible retirement plan within the 60-day rollover period solely because of an error on the part of the financial institution;
- ❑ The funds are deposited into an eligible retirement plan within 1 year from the beginning of the 60-day rollover period; or
- ❑ If it would have been a valid rollover if the financial institution had deposited the funds as instructed.

Individuals who do not qualify for an automatic waiver may apply to the IRS for a waiver of the 60-day rollover requirement. In determining whether to grant a waiver, the IRS will consider all relevant facts and circumstances, including:

- ❑ Whether errors were made by the financial institution (other than those described under automatic waiver, above),
- ❑ Whether the individual was unable to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error,
- ❑ Whether the individual used the amount distributed (for example, in the case of payment by check, whether they cashed the check), and
- ❑ How much time has passed since the date of distribution.

The rules regarding the amount that can be rolled over within the 60-day time period also apply to the amount that can be deposited due to a waiver. For example, if an individual received \$6,000 from their IRA, the most that they can deposit into an eligible retirement plan due to a waiver is \$6,000.

5. Rollover from One IRA into Another

Individuals can withdraw, tax free, all or part of the assets from one traditional IRA if they reinvest them within 60 days in the same or another traditional IRA. Because this is a rollover, the individual cannot deduct the amount that they reinvest in an IRA.

An individual may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called “recharacterizing” the contribution.

6. Waiting Period Between Rollovers

Generally, if an individual makes a tax-free rollover of any part of a distribution from a traditional IRA, they cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. They also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which they made the tax-free rollover. The 1-year period begins on the date the individual receives the IRA distribution, not on the date they roll it over into an IRA.

There is an exception to the rule that amounts rolled over tax-free into an IRA cannot be rolled over tax free again within the 1-year period beginning on the date of the original distribution. The exception applies to a distribution which meets all three of the following requirements.

- ❑ It is made from a failed financial institution by the Federal Deposit Insurance Corporation (FDIC) as receiver for the institution;
- ❑ It was not initiated by either the custodial institution or the depositor;
- ❑ It was made because:
 - The custodial institution is insolvent, and
 - The receiver is unable to find a buyer for the institution.

7. Partial Rollovers

If an individual withdraws assets from a traditional IRA, they can roll over part of the withdrawal tax-free and keep the rest of it. The amount the individual keeps will generally be taxable (except for the part that is a return of nondeductible contributions). The amount kept may be subject to the 10% additional tax on early distributions. Amounts that must be distributed during a particular year under the required distribution rules are not eligible for rollover treatment.

8. Withholding Requirement

Generally, if an eligible rollover distribution is paid directly to an individual, the payer must withhold 20% of it. This applies even if the individual plans to roll over the distribution to a traditional IRA. Withholding can be avoided by selecting a direct rollover.

The 20% withholding requirement does not apply to distributions that are not eligible rollover distributions. However, other withholding rules apply to these distributions. The rules that apply depend on whether the distribution is a periodic distribution or a nonperiodic distribution. For either of these types of distributions, individuals can still choose not to have tax withheld.

9. Direct Rollover Option

An employer's qualified plan must give individuals the option to have any part of an eligible rollover distribution paid directly to a traditional IRA. The plan is not required to give employees this option if their eligible rollover distributions are expected to total less than \$200 for the year.

If an individual chooses the direct rollover option, no tax is withheld from any part of the designated distribution that is directly paid to the trustee of the traditional IRA. If any part is paid to the individual, the payer must withhold 20% of that part's taxable amount.

If an individual decides to roll over any part of a distribution, the direct rollover option will generally be to their advantage. This is because they will not have 20% withholding or be subject to the 10% additional tax under that option. If an individual has a lump-sum distribution and does not plan to roll over any part of it, the distribution may be eligible for special tax treatment that could lower the individual's tax for the distribution year.

The once-a-year limit on IRA-to-IRA rollovers does not apply to eligible rollover distributions from an employer plan. Individuals can roll over more than one distribution from the same employer plan within a year.

10. Life Insurance Contract

Individuals cannot roll over a life insurance contract from a qualified plan into a traditional IRA.

11. Keogh Plans and Rollovers

If an individual is self-employed, they are generally treated as an employee for rollover purposes. Consequently, if they receive an eligible rollover distribution from a Keogh plan (a qualified plan with at least one self-employed participant), they can roll over all or part of the distribution (including a lump-sum distribution) into a traditional IRA.

12. Distribution from a Tax-Sheltered Annuity

If an individual receives an eligible rollover distribution from a tax-sheltered annuity plan (section 403(b) plan), they can roll it over into a traditional IRA.

13. Transfers Incident to Divorce

If an interest in a traditional IRA is transferred from a spouse or former spouse to an individual by a divorce or separate maintenance decree or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as that individual's IRA. The transfer is tax free.

There are two commonly-used methods of transferring IRA assets to a spouse or former spouse. The methods are: (1) changing the name on the IRA and (2) making a direct transfer of IRA assets.

If an individual's spouse or former spouse is allowed to keep his or her portion of the IRA assets in that individual's existing IRA, they can direct the trustee to transfer the assets the individual is permitted to keep directly to a new or existing traditional IRA set up in their name. The name on the IRA containing the individual's spouse's or former spouse's portion of the assets would then be changed to show his or her ownership. If the transfer results in a change in the basis of the traditional IRA of either spouse, both spouses must file Form 8606 and follow the directions in the instructions for that form.

II. Converting from Any Traditional IRA into a ROTH IRA

Individuals can convert amounts from a traditional IRA into a Roth IRA if, for the tax year the individual makes the withdrawal from the traditional IRA, both of the following requirements are met.

- ☐ The individual's modified AGI for Roth IRA purposes is not more than \$100,000; and
- ☐ The individual is not a married individual filing a separate return.

A. ALLOWABLE CONVERSIONS

Individuals can withdraw all or part of the assets from a traditional IRA and reinvest them (within 60 days) in a Roth IRA. The amount that an individual withdraws and timely contributes (convert) to the Roth IRA is called a conversion contribution. If properly (and timely) rolled over, the 10% additional tax on early distributions will not apply.

Individuals must roll over into the Roth IRA the same property they received from the traditional IRA. They can roll over part of the withdrawal into a Roth IRA and keep the rest of it. The amount the individual keeps will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on early distributions.

1. Periodic Distributions

If an individual has started taking substantially equal periodic payments from a traditional IRA, they can convert the amounts in the traditional IRA to a Roth IRA and then continue the periodic payments. The 10% additional tax on early distributions will not apply even if the distributions are not qualified distributions (as long as they are part of a series of substantially equal periodic payments).

2. Required Distributions

Individuals cannot convert amounts that must be distributed from their traditional IRA for a particular year (including the calendar year in which they reach age 70½) under the required distribution rules.

3. Inherited IRAs

If an individual inherited a traditional IRA from someone other than their spouse, it cannot be converted to a Roth IRA.

4. Income

Individuals must include in their gross income distributions from a traditional IRA that they would have had to include in income if they had not converted them into a Roth IRA. They are not required to include in gross income, however, any part of a distribution from a traditional IRA that is a return of their basis.

B. RECHARACTERIZATIONS

Individuals may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution. To recharacterize a contribution, an individual generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for the individual's tax return for the year during which the contribution was made, they can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA.

1. Requirements

If an individual chooses to recharacterize their contribution, they must do all three of the following:

- ☐ Include in the transfer any net income allocable to the contribution. If there was a loss, the net income the individual must transfer may be a negative amount;
- ☐ Report the recharacterization on the individual's tax return for the year during which the contribution was made; and
- ☐ Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

2. No Deduction Allowed

Individuals may not deduct the contribution to the first IRA. Any net income they transfer with the recharacterized contribution is treated as earned in the second IRA. The contribution will not be treated as having been made to the second IRA to the extent any deduction was allowed for the contribution to the first IRA.

3. Effect of Previous Tax-Free Transfers

If an amount has been moved from one IRA to another in a tax-free transfer, such as a rollover, the individual generally cannot recharacterize the amount that was transferred.

4. Recharacterizing to a SEP-IRA or SIMPLE IRA

Roth IRA conversion contributions from a SEP-IRA or SIMPLE IRA can be recharacterized to a SEP-IRA or SIMPLE IRA (including the original SEP-IRA or SIMPLE IRA).

5. Traditional IRA Mistakenly Moved to SIMPLE IRA

If an individual mistakenly rolls over or transfers an amount from a traditional IRA to a SIMPLE IRA, they can later recharacterize the amount as a contribution to another traditional IRA.

6. Recharacterizing Excess Contributions

Individuals can recharacterize only *actual* contributions. If an individual is applying excess contributions for prior years as current contributions, they can recharacterize them only if the recharacterization would still be timely with respect to the tax year for which the applied contributions were actually made.

Example.

Jacob contributed more than he was entitled to in 2008. Jacob cannot recharacterize the excess contributions he made in 2008 after April 15, 2009, because contributions after that date are no longer timely for 2008.

7. Recharacterizing Employer Contributions

Individuals cannot recharacterize employer contributions (including elective deferrals) under a SEP or SIMPLE plan as contributions to another IRA.

8. Reconversions

Individuals cannot convert and reconvert an amount during the same taxable year or, if later, during the 30-day period following a recharacterization. If an individual reconverts during either of these periods, it will be a failed conversion.

C. RECHARACTERIZATION OF CONTRIBUTIONS

To recharacterize a contribution, individuals must notify both the trustee of the first IRA (the one to which the contribution was actually made) and the trustee of the second IRA (the one to which the contribution is being moved) that the person has elected to treat the contribution as having been made to the second IRA rather than the first. The individual must make the notifications by the date of the transfer. Only one notification is required if both IRAs are maintained by the same trustee. The notification(s) must include all of the following information:

- ❑ The type and amount of the contribution to the first IRA that is to be recharacterized;
- ❑ The date on which the contribution was made to the first IRA and the year for which it was made;
- ❑ A direction to the trustee of the first IRA to transfer in a trustee-to-trustee transfer the amount of the contribution and any net income (or loss) allocable to the contribution to the trustee of the second IRA;

- ❑ The name of the trustee of the first IRA and the name of the trustee of the second IRA; and
- ❑ Any additional information needed to make the transfer.

The election to recharacterize and the transfer must both take place on or before the due date (including extensions) for filing your tax return for the year for which the contribution was made to the first IRA.

1. Extension

Ordinarily an individual must choose to recharacterize a contribution by the due date of the return or the due date plus extensions. However, if they miss this deadline, they can still recharacterize a contribution if:

- ❑ Their return was timely filed for the year the choice should have been made; and
- ❑ The individual takes appropriate corrective action within 6 months from the due date of their return excluding extensions.

2. Appropriate Corrective Action

Appropriate corrective action consists of:

- ❑ Notifying the trustee(s) of their intent to recharacterize;
- ❑ Providing the trustee with all necessary information; and
- ❑ Having the trustee transfer the contribution.

Once this is done, the individual must amend their return to show the recharacterization.

3. Decedent

An election to recharacterize can be made on behalf of a deceased IRA owner by the executor, administrator, or other person responsible for filing the decedent's final income tax return.

4. Election Cannot Be Changed

After the transfer has taken place, an individual cannot change their election to recharacterize.

5. Same Trustee

Recharacterizations made with the same trustee can be made by redesignating the first IRA as the second IRA, rather than transferring the account balance.

D. REPORTING A RECHARACTERIZATION

If an individual elects to recharacterize a contribution to one IRA as a contribution to another IRA, they must report the recharacterization on their tax return as directed by Form 8606 and its instructions. They must treat the contribution as having been made to the second IRA.

Example.

On June 1, 2007, Christine properly and timely converted her traditional IRAs to a Roth IRA. At the time, she and her husband, Lyle, expected to have modified AGI of less than \$100,000 for 2007. In December, Lyle received an unexpected bonus that increased his and Christine's modified AGI to more than \$100,000. In January 2008, to make the necessary adjustment to remove the unallowable conversion, Christine set up a traditional IRA with the same trustee. Also in January 2008, she instructed the trustee of the Roth IRA to make a trustee-to-trustee transfer of the conversion contribution made to the Roth IRA (including net income allocable to it since the conversion) to the new traditional IRA. She also notified the trustee that she was electing to recharacterize the contribution to the Roth IRA and treat it as if it had been contributed to the new traditional IRA. Because of the recharacterization, Lyle and Christine have no taxable income from the conversion to report for 2007, and the resulting rollover to a traditional IRA is not treated as a rollover for purposes of the one-rollover-per-year rule.

If an individual has more than one IRA, they must figure the amount to be recharacterized only on the account from which they withdraw the contribution.

III. Distributions

A. WHEN ASSETS MUST BE WITHDRAWN

Individuals cannot keep funds in a traditional IRA indefinitely. Eventually they must be distributed. If there are no distributions, or if the distributions are not large enough, the owner may have to pay a 50% excise tax on the amount not distributed as required. The requirements for distributing IRA funds differ, depending on whether an individual is the IRA owner or the beneficiary of a decedent's IRA. Note also that amounts that must be distributed (required minimum distributions) during a particular year are not eligible for rollover treatment.

B. IRA OWNERS

If an individual is the owner of a traditional IRA, they must start receiving distributions from the IRA by April 1 of the year following the year in which they reach age 70½. April 1 of the year following the year in which they reach age 70½ is referred to as the required beginning date.

Persons must receive at least a minimum amount for each year starting with the year they reach age 70½ (their 70½ year). If the individual did not receive that minimum amount in their 70½ year, then they must receive distributions for their 70½ year by April 1 of the next year.

If an IRA owner dies after reaching age 70½, but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date.

Even if an individual begins receiving distributions before they reach age 70½, they must still begin calculating and receiving required minimum distributions by their required beginning date.

1. More Than Minimum Received

If, in any year, an individual receives more than the required minimum distribution for that year, they will not receive credit for the additional amount when determining the minimum required distributions for future years. This does not mean that the person does not reduce their IRA account balance. It means that if they receive more than their required minimum distribution in one year, they cannot treat the excess (the amount that is more than the required minimum distribution) as part of their required minimum distribution for any later year. However, any amount distributed in an individual's 70½ year will be credited toward the amount that must be distributed by April 1 of the following year.

2. Distributions After the Required Beginning Date

The required minimum distribution for any year after the year the owner of an IRA turns 70½ must be made by December 31 of that later year.

Example.

Martin reaches age 70½ on August 20, 2007. For 2007, he must receive the required minimum distribution from his IRA by April 1, 2008. Martin must receive the required minimum distribution for 2008 by December 31, 2008.

C. FIGURING THE OWNER'S REQUIRED MINIMUM DISTRIBUTION

An individual's required minimum distribution for each year can be figured by dividing the IRA account balance (defined next) as of the close of business on December 31 of the preceding year by the applicable distribution period or life expectancy.

1. IRA Account Balance

The IRA account balance is the amount in the IRA at the end of the year preceding the year for which the required minimum distribution is being figured. Contributions increase the account balance in the year they are made. If a contribution for last year is not made until after December 31 of last year, it increases the account balance for this year, but not for last year. Contributions made after December 31 of last year in determining an individual's required minimum distribution for this year should be disregarded.

2. Distributions

Distributions reduce the account balance in the year they are made. If a distribution for last year is not made until after December 31 of last year, it reduces the account balance for this year, but not for last year. Disregard distributions made after December 31 of last year in determining an individual's required minimum distribution for this year.

Example 1.

Laura was born on October 1, 1937. She is an unmarried participant in a qualified defined contribution plan. She reaches age 70½ in 2008. Her required beginning date is April 1, 2009. As of December 31, 2007, her account balance was \$26,500. No rollover or recharacterization amounts were outstanding. The applicable distribution period for someone her age (71) is 26.5 years. Her required minimum distribution for 2008 is \$1,000 ($\$26,500 \div 26.5$). That amount is distributed to her on April 1, 2009.

Example 2.

Joe, born October 1, 1937, reached 70½ in 2008. His wife (his beneficiary) turned 56 in September 2008. He must begin receiving distributions by April 1, 2008. Joe's IRA account balance as of December 31, 2007, is \$30,100. Because Joe's wife is more than 10 years younger than Joe and is the sole beneficiary of his IRA, Joe uses Table II. Based on their ages at year end (December 31, 2008), the joint life expectancy for Joe (age 71) and his wife (age 56) is 30.1 years. The required minimum distribution for 2008, Joe's first distribution year (his 70½ year), is \$1,000 ($\$30,100 \div 30.1$). This amount is distributed to Joe on April 1, 2009.

3. Distribution Period

This is the maximum number of years over which an individual is allowed to take distributions from their IRA.

4. Life Expectancy

The IRS publishes life expectancy tables for use in this calculation.

D. IRA BENEFICIARIES

The rules for determining required minimum distributions for beneficiaries depend on whether the beneficiary is an individual.

1. Surviving Spouse

If the beneficiary is the surviving spouse who is the sole beneficiary of their deceased spouse's IRA, they may elect to be treated as the owner and not as the beneficiary. If they elect to be treated as the owner, they must determine the required minimum distribution (if any) as if they were the owner beginning with the year they elect or are deemed to be the owner. However, if the individual becomes the owner in the year their

deceased spouse died, they are not required to determine the required minimum distribution for that year using their own life; rather, they can take the deceased owner's required minimum distribution for that year (to the extent it was not already distributed to the owner before his or her death).

2. Taking Balance Within 5 Years

A beneficiary who is an individual may be required to take the entire account by the end of the fifth year following the year of the owner's death. If this rule applies, no distribution is required for any year before that fifth year.

3. Death of a Beneficiary

If a person who is a beneficiary as of the owner's date of death dies before September 30 of the year following the year of the owner's death without disclaiming entitlement to benefits, that individual, rather than his or her successor beneficiary, continues to be treated as a beneficiary for determining the distribution period.

4. Death of Surviving Spouse

If the designated beneficiary is the owner's surviving spouse, and he or she dies before he or she was required to begin receiving distributions, the surviving spouse will be treated as if he or she were the owner of the IRA. However, this rule does not apply to the surviving spouse of a surviving spouse.

E. MISCELLANEOUS RULES FOR REQUIRED MINIMUM DISTRIBUTIONS

1. Installments Allowed

The yearly required minimum distribution can be taken in a series of installments (monthly, quarterly, etc.) as long as the total distributions for the year are at least as much as the minimum required amount.

2. More Than One IRA

If an individual has more than one traditional IRA, they must determine a separate required minimum distribution for each IRA. However, they can total these minimum amounts and take the total from any one or more of the IRAs.

Example.

Sara, born August 1, 1936, became 70½ on February 1, 2007. She has two traditional IRAs. She must begin receiving her IRA distributions by April 1, 2008. On December 31, 2006, Sara's account balance from IRA A was \$10,000; her account balance from IRA B was \$20,000. Sara's brother, age 64 as of his birthday in 2007, is the beneficiary of IRA A. Her husband, age 78 as of his birthday in 2007, is the beneficiary of IRA B.

Sara's required minimum distribution from IRA A is \$377 ($\$10,000 \div 26.5$ (the distribution period for age 71 per Table III)). The amount of the required minimum distribution from IRA B is \$755 ($\$20,000 \div 26.5$). The amount that must be withdrawn by Sara from her IRA accounts by April 1, 2008 is \$1,132 ($\$377 + \755).

3. More Than Minimum Received

If, in any year, an individual receives more than the required minimum amount for that year, they will not receive credit for the additional amount when determining the minimum required amounts for future years. This does not mean that they do not reduce their IRA account balance. It means that if they receive more than their required minimum distribution in one year, they cannot treat the excess (the amount that is more than the required minimum distribution) as part of their required minimum distribution for any later year. However, any amount distributed in their 70½ year will be credited toward the amount that must be distributed by April 1 of the following year.

Example.

Justin became 70½ on December 15, 2007. Justin's IRA account balance on December 31, 2006, was \$38,400. He figured his required minimum distribution for 2006 as \$1,401 ($\$38,400 \div 27.4$). By December 31, 2007, he had actually received distributions totaling \$3,600, \$2,199 more than was required. Justin cannot use that \$2,199 to reduce the amount he is required to withdraw for 2008, but his IRA account balance is reduced by the full \$3,600 to figure his required minimum distribution for 2008. Justin's reduced IRA account balance on December 31, 2007, was \$34,800. Justin figured his required minimum distribution for 2008 as \$1,313 ($\$34,800 \div 26.5$). During 2008, he must receive distributions of at least that amount.

4. Multiple Individual Beneficiaries

If as of September 30 of the year following the year in which the owner dies there is more than one beneficiary, the beneficiary with the shortest life expectancy will be the designated beneficiary if both of the following apply:

- ☐ All of the beneficiaries are individuals; and
- ☐ The account or benefit has not been divided into separate accounts or shares for each beneficiary.

5. Separate Accounts

Separate accounts with separate beneficiaries can be set up at any time, either before or after the owner's required beginning date. If separate accounts with separate beneficiaries are set up, the separate accounts are not combined for required minimum distribution purposes until the year after the separate accounts are established, or if later, the date of death.

As a general rule, the required minimum distribution rules separately apply to each account. However, the distribution period for an account is separately determined (disregarding beneficiaries of the other account(s)) only if the account was set up by the end of the year following the year of the owner's death. The separate account rules cannot be used by beneficiaries of a trust.

6. Trust as Beneficiary

A trust cannot be a designated beneficiary even if it is a named beneficiary. However, the beneficiaries of a trust will be treated as having been designated as beneficiaries if all of the following are true:

- ❑ The trust is a valid trust under state law, or would be but for the fact that there is no corpus;
- ❑ The trust is irrevocable or will, by its terms, become irrevocable upon the death of the owner;
- ❑ The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the owner's benefit are identifiable from the trust instrument;
- ❑ The IRA trustee, custodian, or issuer has been provided with either a copy of the trust instrument with the agreement that if the trust instrument is amended, the administrator will be provided with a copy of the amendment within a reasonable time, or all of the following:
 - A list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement).
 - Certification that, to the best of the owner's knowledge, the list is correct and complete and that the requirements above are met.
- ❑ An agreement that, if the trust instrument is amended at any time in the future, the owner will, within a reasonable time, provide to the IRA trustee, custodian, or issuer corrected certifications to the extent that the amendment changes any information previously certified; and
- ❑ An agreement to provide a copy of the trust instrument to the IRA trustee, custodian, or issuer upon demand.

The deadline for providing the beneficiary documentation to the IRA trustee, custodian, or issuer is October 31 of the year following the year of the owner's death. If the beneficiary of the trust is another trust and the above requirements for both trusts are met, the beneficiaries of the other trust will be treated as having been designated as beneficiaries for purposes of determining the distribution period. The separate account rules cannot be used by beneficiaries of a trust.

F. TAXATION OF DISTRIBUTIONS

In general, distributions from a traditional IRA are taxable in the year they are received. Distributions from traditional IRAs included in income are taxed as ordinary income.

1. Distributions Fully or Partly Taxable

Distributions from a traditional IRA may be fully or partly taxable, depending on whether the individual's IRA includes any nondeductible contributions.

If only deductible contributions were made to an individual's traditional IRA (or IRAs, if they have more than one), the individual has no basis in their IRA. Because they have no basis in their IRA, any distributions are fully taxable when received.

If an individual made nondeductible contributions to any of their traditional IRAs, they have a cost basis (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed. They are a return of the individual's investment in their IRA.

Only the part of the distribution that represents nondeductible contributions (their cost basis) is tax-free. If nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if there are any). Until all of an individual's basis has been distributed, each distribution is partly nontaxable and partly taxable.

2. Recognizing Losses on Traditional IRA Investments

If an individual has a loss on their traditional IRA investment, they can recognize (include) the loss on their income tax return, but only when all the amounts in all of their traditional IRA accounts have been distributed and the total distributions are less than the individual's unrecovered basis, if any. Their basis is the total amount of the nondeductible contributions in their traditional IRAs. The individual can claim the loss as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040.

Example.

Bill King has made nondeductible contributions to a traditional IRA totaling \$2,000, giving him a basis at the end of 2006 of \$2,000. By the end of 2007, his IRA earns \$400 in interest income. In that year, Bill receives a distribution of \$600 (\$500 basis + \$100 interest), reducing the value of his IRA to \$1,800 (\$2,000 + 400 - 600) at year's end. Bill figures the taxable part of the distribution and his remaining basis on Form 8606.

In 2008, Bill's IRA has a loss of \$500. At the end of that year, Bill's IRA balance is \$1,300 (\$1,800 - 500). Bill's remaining basis in his IRA is \$1,500 (\$2,000 - 500). Bill receives the \$1,300 balance remaining in the IRA. He can claim a loss for 2008 of \$200 (the \$1,500 basis minus the \$1,300 distribution of the IRA balance).

3. Withholding

Federal income tax is withheld from distributions from traditional IRAs unless the owner chooses not to have tax withheld.

The amount of tax withheld from an annuity or a similar periodic payment is based on the individual's marital status and the number of withholding allowances they claim on their withholding certificate (Form W-4P). If an individual has not filed a certificate, tax will be withheld as if the individual were a married individual claiming three withholding allowances. Generally, tax will be withheld at a 10% rate on nonperiodic distributions.

IV. Acts That Result in Penalties or Additional Taxes

The tax advantages of using traditional IRAs for retirement savings can be offset by additional taxes and penalties if an individual does not follow the rules. There are additions to the regular tax for using their IRA funds in prohibited transactions. There are also additional taxes for the following activities:

- ☐ Investing in collectibles;
- ☐ Making excess contributions;
- ☐ Taking early distributions; and
- ☐ Allowing excess amounts to accumulate (failing to take required distributions).

There are penalties for overstating the amount of nondeductible contributions and for failure to file Form 8606, if required.

A. PROHIBITED TRANSACTIONS

Generally, a prohibited transaction is any improper use of a traditional IRA account or annuity by the owner, their beneficiary, or any disqualified person. Disqualified persons include the individual's fiduciary and members of their family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of prohibited transactions with a traditional IRA:

- ☐ Borrowing money from it;
- ☐ Selling property to it;
- ☐ Receiving unreasonable compensation for managing it;
- ☐ Using it as security for a loan; and
- ☐ Buying property for personal use (present or future) with IRA funds.

1. Fiduciary

A fiduciary includes anyone who does any of the following:

- ❑ Exercises any discretionary authority or discretionary control in managing the individual's IRA or exercises any authority or control in managing or disposing of its assets;
- ❑ Provides investment advice to the individual's IRA for a fee, or has any authority or responsibility to do so; or
- ❑ Has any discretionary authority or discretionary responsibility in administering the individual's IRA.

2. Effect on an IRA Account

Generally, if an owner or their beneficiary engages in a prohibited transaction in connection with a traditional IRA account at any time during the year, the account stops being an IRA as of the first day of that year.

3. Effect on Owner or Beneficiary

If an individual's account stops being an IRA because the individual or their beneficiary engaged in a prohibited transaction, the account is treated as distributing all its assets to the owner of the account at their fair market values on the first day of the year. If the total of those values is more than the individual's basis in the IRA, they will have a taxable gain that is includible in their income. The distribution may be subject to additional taxes or penalties.

4. Borrowing on an Annuity Contract

If an individual borrows money against their traditional IRA annuity contract, they must include in their gross income the fair market value of the annuity contract as of the first day of their tax year. They may have to pay the 10% additional tax on early distributions.

5. Pledging an Account as Security

If an individual uses a part of their traditional IRA account as security for a loan, that part is treated as a distribution and is included in the individual's gross income. They may have to pay the 10% additional tax on early distribution.

6. Owner Participation

If an individual participates in the prohibited transaction with their employer or the association, their account is no longer treated as an IRA.

7. Taxes on Prohibited Transactions

If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

B. EXEMPT TRANSACTIONS

The following two types of transactions are not prohibited transactions if they meet the requirements that follow:

- ❑ Payments of cash, property, or other consideration by the sponsor of the individual's traditional IRA to themselves (or members of their family);
 - ❑ The receipt of services at reduced or no cost from the bank where their traditional IRA is established or maintained;
1. Payments of cash, property, or other consideration. Even if a sponsor makes payments to an individual or their family, there is no prohibited transaction if all three of the following requirements are met:
 - The payments are for establishing a traditional IRA or for making additional contributions to it;
 - The IRA is established solely to benefit the individual, their spouse, and the individual's or their spouse's beneficiaries;
 - During the year, the total fair market value of the payments the individual receives is not more than: \$10 for IRA deposits of less than \$5,000, or \$20 for IRA deposits of \$5,000 or more.

If the consideration is group term life insurance, requirements (1) and (3) do not apply if no more than \$5,000 of the face value of the insurance is based on a dollar-for-dollar basis on the assets in the individual's IRA.

2. Services received at reduced or no cost. Even if a sponsor provides services at reduced or no cost, there is no prohibited transaction if all five of the following requirements are met:
 - The traditional IRA qualifying the individual to receive the services is established and maintained for the benefit of the individual, their spouse and their beneficiaries;
 - The bank itself can legally offer the services;
 - The services are provided in the ordinary course of business by the bank (or a bank affiliate) to customers who qualify but do not maintain an IRA (or a Keogh plan);
 - The determination, for a traditional IRA, of who qualifies for these services is based on an IRA (or a Keogh plan) deposit balance equal to the lowest qualifying balance for any other type of account; and

- The rate of return on a traditional IRA investment that qualifies is not less than the return on an identical investment that could have been made at the same time at the same branch of the bank by a customer who is not eligible for (or does not receive) these services.

C. INVESTMENT IN COLLECTIBLES

If an individual's traditional IRA invests in collectibles, the amount invested is considered distributed to them in the year invested. The individual may have to pay the 10% additional tax on early distributions. Collectibles include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages and certain other tangible personal property.

An individual's IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

D. TAXES ON EXCESS CONTRIBUTIONS

In general, if the excess contributions for a year are not withdrawn by the date an individual's return for the year is due (including extensions), the individual is subject to a 6% tax. They must pay the 6% tax each year on excess amounts that remain in their traditional IRA at the end of their tax year. The tax cannot be more than 6% of the value of the IRA as of the end of their tax year.

Example.

For 2008, Paul Jones is 45 years old and single, his compensation is \$31,000, and he contributed \$5,500 to his traditional IRA. Paul has made an excess contribution to his IRA of \$500 (\$5,500 minus the \$5,000 limit). The contribution earned \$5 interest in 2008 and \$6 interest in 2009 before the due date of the return, including extensions. He does not withdraw the \$500 or the interest it earned by the due date of his return, including extensions.

Paul figures his additional tax for 2008 by multiplying the excess contribution (\$500) shown on line 16, Form 5329, by .06, giving him an additional tax liability of \$30. He enters the tax on line 17, Form 5329, and on line 59, Form 1040.

An individual does not have to pay the 6% tax if they withdraw an excess contribution made during a tax year and they also withdraw any interest or other income earned on the excess contribution. They must complete the withdrawal by the date their tax return for that year is due, including extensions.

CHAPTER 12 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. A taxpayer is eligible to make contributions to an Individual Retirement Account:
 - a) during any year in which they have wages, regardless of age
 - b) any year in which they are under 55 years of age, even if they have no taxable compensation
 - c) any year they have taxable income and are not covered by any other type of retirement plan
 - d) any year they have not reached age 70½ and have taxable compensation
2. Which of the following are attributes of a Roth IRA:
 - a) taxpayers must begin receiving required minimum distributions by April 1 of the year following the year they reach age 70½
 - b) distributions from Roth IRAs are not taxed as long as the owner meets certain criteria
 - c) distributions from a Roth IRA are taxed as ordinary income, but if the taxpayer made nondeductible contributions, not all of the distribution is taxable
 - d) both a and b above
3. Individuals may establish an IRA by purchasing an annuity.
 - a) true
 - b) false
4. If an individual fails to report nondeductible contributions, all of the contributions to their traditional IRA will be treated as deductible.
 - a) true
 - b) false
5. Individuals may generally roll one retirement plan or IRA into another without tax or penalty so long as the distribution from the first plan is rolled into the second within what period of time:
 - a) 10 days
 - b) 30 days
 - c) 60 days
 - d) 90 days

6. Generally, if an eligible rollover distribution is paid directly to an individual, the payer must withhold 20% of it.
- a) true
 - b) false
7. Under no circumstances are individuals permitted to convert amounts from a traditional IRA into a Roth IRA.
- a) true
 - b) false
8. In order for a recharacterization of IRA contributions to be considered timely, only the election to recharacterize must take place on or before the due date (including extensions) for filing the tax return for the year for which the contribution was made to the first IRA.
- a) true
 - b) false
9. Which of the following rules apply to the distribution of money from an IRA:
- a) money can remain in an IRA indefinitely without penalty
 - b) there is a 50% excise tax imposed on money that should have been distributed from an IRA but was not
 - c) owners of a traditional IRA must begin taking distributions in the year they reach age 70½
 - d) both b and c above
10. The yearly required distribution from an IRA must be taken in one lump sum.
- a) true
 - b) false
11. Distributions from a traditional IRA are generally taxable.
- a) true
 - b) false
12. Contributions to an IRA above the federally-allowed maximum are subject to:
- a) forfeiture
 - b) a 6% tax
 - c) a 12% tax
 - d) a 15% tax

CHAPTER 12 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Although the individual must have taxable compensation, the compensation need not be wages. In addition, there is a maximum age.

B: Incorrect. The individual must have taxable income and not reach age 70½.

C: Incorrect. Persons may be covered by another retirement plan so long as they meet the eligibility requirements.

D: Correct. Persons must meet both requirements for any year they wish to make a contribution to their IRA.

(See page 12-1 of the course material.)

2. A: Incorrect. This is a characteristic of a traditional IRA and not a Roth IRA. The reason this is not required for Roth IRAs is because the owner has already paid tax on the money before it was invested.

B: Correct. This is one of the main differences between a Roth and a traditional IRA. The taxpayer uses after-tax monies to fund the account and can withdraw them without further tax on the distributions.

C: Incorrect. They are not taxed when withdrawn as the account is funded with after-tax rather than pre-tax money.

D: Incorrect. Only B is a correct statement about Roth IRAs.

(See page 12-2 of the course material.)

3. **A: True is correct.** An IRA can be established by purchasing an annuity contract or an endowment contract from a life insurance company. An individual retirement annuity must be issued in the investor's name as the owner, and either they or their beneficiaries who survive are the only ones who can receive the benefits or payments.

B: False is incorrect. Subject to certain limitations, annuities can be used as a vehicle for an IRA.

(See page 12-4 of the course material.)

4. **A: True is correct.** All distributions from their IRA will be taxed unless the individual can show with satisfactory evidence that nondeductible contributions were made.

B: False is incorrect. Individuals do not have to designate a contribution as nondeductible until they file their tax return. If they fail to designate the nondeductible contributions, all of the contributions to their traditional IRA will be treated as deductible, and the distributions can be taxed.

(See page 12-12 of the course material.)

5. A: Incorrect. Account holders actually have 60 days from the time they receive the distribution from the first account.

B: Incorrect. The allowable time period is 60 days.

C: Correct. Taxpayers are generally given 60 days to take distributions from one retirement account and roll them into another before the first distribution is considered a taxable event.

D: Incorrect. While there are circumstances that would warrant additional time, the general rule gives taxpayers 60 days to roll over the proceeds.

(See page 12-15 of the course material.)

6. **A: True is correct.** This applies even if the individual plans to roll over the distribution to a traditional IRA.

B: False is incorrect. Withholding can be avoided by selecting a direct rollover rather than having the payment made directly to the individual.

(See page 12-17 of the course material.)

7. A: True is incorrect. If an individual qualifies, they can convert amounts from a traditional IRA to a Roth IRA.

B: False is correct. Individuals can make this conversion if the individual's modified AGI for Roth IRA purposes is not more than \$100,000, and the individual is not a married individual filing a separate return.

(See page 12-19 of the course material.)

8. A: True is incorrect. Both the election and the actual transfer must occur prior to the due date (including extensions) for filing the tax return for the year in which the contribution was made to the first IRA.

B: False is correct. The actual transfer must also occur by the due date (including extensions) for filing the tax return for the year in which the contribution was made to the initial IRA.

(See page 12-22 of the course material.)

9. A: Incorrect. Money in an IRA must be distributed at certain times or is subject to an expensive excise tax. This is true even if the retiree does not need the money and would prefer to leave it to his/her heirs.

B: Incorrect. The 50% excise tax is imposed on money that was not properly distributed from an IRA. However, this is not the best answer.

C: Incorrect. This is true for traditional IRAs held by the original account holder. However, this is not the most correct answer.

D: Correct. For a traditional IRA, account owners must begin taking minimum distributions in the year they reach age 70½. Failure to do so results in the imposition of an excise tax equal to 50% of the money that was improperly left in the account.

(See page 12-23 of the course material.)

10. A: True is incorrect. Installments are permissible.

B: False is correct. The yearly required minimum distributions from an IRA can be taken in a series of installments as long as the total distributions for the year are at least as much as the minimum required amount.

(See page 12-26 of the course material.)

11. **A: True is correct.** Distributions from a traditional IRA are generally taxable either fully or partially depending on whether the individual's IRA includes any nondeductible contributions. If only deductible contributions were made to an individual's traditional IRA, they have no basis in their IRA. This means that all distributions will be fully taxable.

B: False is incorrect. Distributions from a traditional IRA are normally taxed as ordinary income in the year they are received.

(See page 12-29 of the course material.)

12. A: Incorrect. While such excess contributions are subject to tax until they are withdrawn, the funds themselves are not forfeited.

B: Correct. If these excess funds are not withdrawn prior to the date the taxpayer's return is due, they are subject to a 6% tax. This tax is due every year the excess amounts remain in their account at the end of their normal tax year.

C: Incorrect. The actual tax is only 6%.

D: Incorrect. The penalty is a 6% tax.

(See page 12-33 of the course material.)

Chapter 13: Taxation of Social Security Benefits

Some people who get social security benefits have to pay income taxes on their benefits. This fact could affect an individual's planning for when they begin receiving their benefits and what other type of work, if any, they will do once they begin receiving those benefits. This chapter provides a basic overview of how benefits are calculated and paid and the rules governing the taxation of benefits.

I. Overview of the System

Social security is part of the retirement plans of almost every worker in the United States. It has been around for approximately 70 years. The Social Security system is designed so that there is a link between how much workers and their employers pay into the system over their working years and how much they will get in benefits. Basically, high-wage earners receive a higher benefit payment than low-wage earners. However, the benefit "formula" is set up so that lower wage earners will get a higher percentage of their pre-retirement earnings.

Workers can retire as early as age 62 and get reduced social security benefits. Or they can wait until full retirement age and receive full benefits. For example, someone born in 1955 would generally receive a retirement benefit of \$1,000 at full retirement age (66 years and two months). However, if they elected to retire early and begin taking benefits at age 62, that benefit would be reduced to \$741.

Generally, out of every dollar a worker pays in social security taxes:

- ❑ 85 cents goes to a trust fund that pays monthly benefits to retirees and their families and to widows, widowers and children of workers who have died; and
- ❑ 15 cents goes to a trust fund that pays benefits to people with disabilities and their families.

Social security taxes also pay for administering the social security program. The entire amount of taxes individuals pay for Medicare (1.45 percent of an employee's earnings) goes to a trust fund that pays for some of the costs of hospital and related care of Medicare beneficiaries.

A. QUALIFICATIONS FOR RETIREMENT BENEFITS

When an individual is employed and pays social security taxes (called FICA on some pay stubs), they earn social security credits. Most people earn the maximum of four credits per year.

1. How Credits Are Earned

Workers qualify for social security benefits by earning credits when they work in a job or are self-employed and pay social security taxes (call self-employment tax for persons who are self-employed).

Credits are based on the amount of a worker's earnings. Each individual's work history is used to determine his or her eligibility for retirement or disability benefits as well as his or her family's eligibility for survivor benefits. In 2008, each worker received one credit for each \$1,050 of earnings, up to a maximum of four credits per year.

Each year the amount of earnings required to earn a credit increases slightly as average earnings levels increase. The credits an individual earns remain on their social security record even if they change jobs or have no earnings for a period of time.

2. Special Rules for Some Jobs

Special rules for earning social security coverage apply to certain types of work. If an individual is self-employed, they earn social security credits the same way employees do (one credit for each \$1,050 in net earnings, but no more than four credits per year). Special rules apply if an individual has net annual earnings of less than \$400.

Individuals in the military earn social security credits the same way civilian employees do. However, there might be additional earnings credits under certain conditions.

There are special rules about how workers earn credits for other kinds of work. Some of these jobs are domestic work and farm work and work for a church or church-controlled organization that does not pay social security taxes.

3. Number of Credits Required

The number of credits needed to get retirement benefits depends on each individual's date of birth. Persons born in 1929 or later, for example, need 40 credits – or 10 years of work – to qualify. People born before 1929 need fewer than 40 credits (39 credits if born in 1928; 38 credits if born in 1927; etc.). Most people earn more credits than are necessary to qualify for benefits. However, extra credits will not increase a person's benefit level.

B. AMOUNT OF RETIREMENT BENEFIT

An individual's benefit amount is based on his or her earnings averaged over most of their working career. Higher lifetime earnings result in higher benefits. If an individual has some years of no earnings or low earnings, their benefit amount may be lower than if they had worked steadily.

An individual's benefit amount also is affected by their age at the time they start receiving benefits. Individuals who begin receiving retirement benefits at age 62 (the earliest possible retirement age) will have a lower level of benefits than if they had waited to a later date to retire.

Each year, every individual who has credits registered should receive, about three months before their birthday, a *Social Security Statement* that provides a record of their earnings, estimates of their social security benefits for early retirement, full retirement and retirement at age 70. It also provides an estimate of the disability benefits the individual could receive if they become severely disabled before they are eligible for full retirement, as well as estimates of the amount of benefits paid to their spouse and other eligible family members due to retirement, disability or death.

1. Full Retirement Age

Because of longer life expectancies, the Social Security law was changed in 1983 to increase the full retirement age in gradual steps until it reaches age 67. This change began in the year 2003, and affects people born in 1938 and later. The new rules are shown on Table 13-1, below.

2. Early Retirement

Individuals can elect to start their social security benefits as early as age 62, but the benefit amount they receive will be less than his/her full retirement benefit.

If an individual elects to take early retirement, their benefits will be permanently reduced based on the number of months they will receive checks before reaching full retirement age. If an individual's full retirement age is 67, the reduction for starting their social security at age 62 is about 30 percent; at age 63, it is about 25 percent; at age 64, it is about 20 percent; at age 65, it is about 13.3 percent; and at age 66, it is about 6.7 percent.

Table 13-1. Age to Receive Full Social Security Benefits

Year of Birth	Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

As a general rule, early retirement will give an individual about the same total social security benefits over their lifetime, but in smaller amounts to take into account the longer period over which they will receive them.

Some people stop working before they reach age 62. In that case, it is important to remember that during years with no earnings, they will miss the opportunity to increase their benefit amount by replacing lower earnings years with higher earnings years.

3. Disability Retirement

Sometimes poor health forces people to retire early. If an individual is unable to continue working because of poor health, they should consider applying for social security disability benefits. The amount of the disability benefit is the same as a full, unreduced retirement benefit. If an individual is receiving social security disability benefits when they reach full retirement age, those benefits will be converted to retirement benefits.

4. Delayed Retirement

Not everyone retires at full retirement age. An individual may decide to continue working full time beyond that time. In that case, the individual who elects to continue working can increase their social security benefit in two ways:

- ❑ Each additional year an individual works adds another year of earnings to their social security record. Higher lifetime earnings may result in higher benefits when they eventually do retire.
- ❑ In addition, an individual's benefit will be increased by a certain percentage if they choose to delay receiving retirement benefits. These increases will be added in automatically from the time the person reaches their full retirement age until they start taking their benefits, or reach age 70. The percentage varies depending on each individual's year of birth.

For example, an individual born in 1943 or later will receive an additional 8 percent per year (2/3 of 1 percent per month) in the amount of their benefit for each year they delay signing up for social security beyond their full retirement age. This is shown more fully in Table 13-2, below.

Table 13-2. Increases for Delayed Retirement

Year of Birth	Yearly Rate of Increase
1933-1934	5.5%
1935-1936	6.0%
1937-1938	6.5%
1939-1940	7.0%
1941-1942	7.5%
1943 or later	8.0%

C. CHOOSING A RETIREMENT DATE

If an individual plans to start their retirement benefits after age 62, it is a good idea to contact Social Security in advance to see which month is best to claim benefits. In some cases, the choice of a retirement month could mean additional benefits.

It may be advantageous, for example, to have social security benefits start in January, even if the recipient does not plan to retire until later in the year. Depending on an individual's earnings and benefit amount, it may be possible for them to start collecting benefits even though they continue to work. Under current rules, many people can receive the most benefits possible with an application that is effective in January.

If an individual is not working, or the person's annual earnings are under the earnings limit, or they plan to start collecting social security when they turn 62, they should apply for benefits three months before the date they want their benefits to start.

D. SOCIAL SECURITY BENEFITS

There are five major categories of benefits paid for through social security taxes: retirement, disability, family benefits, survivors and Medicare. (SSI benefits, which are not financed by social security taxes, are discussed in another section.)

1. Retirement

Benefits are payable at full retirement age (with reduced benefits available as early as age 62) for anyone with enough social security credits. The full retirement age is 65 for persons born before 1938. The age gradually rises until it reaches 67 for persons born in 1960 or later. People who delay retirement beyond full retirement age get special credit for each month they do not receive a benefit until they reach age 70.

2. Disability

Benefits can be paid to people at any age who have enough social security credits and who have a severe physical or mental impairment that is expected to prevent them from doing "substantial" work for a year or more or who have a condition that is expected to result in death. Generally, earnings of \$940 or more per month are considered substantial. The disability program includes incentives to smooth the transition back into the workforce, including continuation of benefits and health care coverage while a person attempts to work.

3. Survivor Benefits

Certain family members of a deceased worker may be able to get survivors benefits, even though the deceased worker did not work long enough to qualify for retirement benefits. Dependent children may get survivors benefits if the deceased person had 1½ years of work (6 credits) in the three years before his or her death. Their benefits could continue until they reach age 18 (or age 19 if they are attending an elementary or secondary school full time).

A widow or widower may be able to get benefits. Widow(er)s can begin receiving benefits at age 60 or age 50 if disabled. If an individual is receiving widows or widowers (including divorced widows or widowers) benefits, they can switch to their own retirement benefits – assuming they are eligible and their retirement rate is higher than the widow(er)'s rate – as early as age 62. In many cases, a widow(er) can begin receiving one benefit at a reduced rate and then switch to the other benefit at an unreduced rate at full retirement age. The rules vary depending on the situation.

4. Benefits For Family Members

If an individual is receiving retirement benefits, some members of their family also can receive benefits. Those who can include:

- ❑ A decedent's wife or husband age 62 or older;
- ❑ A decedent's wife or husband under age 62, if she or he is taking care of their child who is under age 16 or disabled;

- ❑ The decedent's former wife or husband age 62 or older;
- ❑ Children up to age 18;
- ❑ Children age 18-19, if they are full-time students through grade 12; and
- ❑ Children over age 18, if they are disabled.

5. Spouse's Benefits

A spouse receives one-half of the retired worker's full benefit unless the spouse begins collecting benefits before reaching full retirement age. In that case, the amount of the spouse's benefit is permanently reduced by a percentage based on the number of months before she or he reaches 65. For example, if an individual's spouse begins collecting benefits at 64, the benefit amount would be about 46 percent of the individual's full benefit. At age 63, it would be about 42 percent and 37.5 percent at age 62. However, if the spouse is taking care of a child who is under age 16 or disabled and receiving social security benefits, the spouse gets full benefits, regardless of age.

If an individual is eligible for both their own retirement benefits and for benefits as a spouse, Social Security will always pay the individual's own benefit first. If the benefit as a spouse is higher than their retirement benefit, they will get a combination of benefits equaling the higher spouse benefit.

Example.

Mary Ann qualifies for a retirement benefit of \$250 and a wife's benefit of \$400. At full retirement age, she will receive her own \$250 retirement benefit and Social Security will add \$150 from her wife's benefit, for a total of \$400. If she takes her retirement benefit at any time before she reaches full retirement age, both amounts will be reduced.

6. Maximum Family Benefits

If an individual has children eligible for social security, each will receive up to one-half of that individual's full benefit. But there is a limit to the amount of money that can be paid to a family. If the total benefits due a spouse and children exceed this limit, their benefits will be reduced proportionately. The individual's benefit will not be affected.

7. Benefits For A Divorced Spouse

A divorced spouse can get benefits on a former husband's or wife's social security record if the marriage lasted at least 10 years. The divorced spouse must be 60 or older and unmarried. If the spouse has been divorced at least two years, he or she can get benefits, even if the worker is not retired. However, the worker must have enough credits to qualify for benefits and be age 62 or older. The amount of benefits a divorced spouse gets has no effect on the amount of benefits a current spouse can get.

II. Taxation of Benefits

A. OVERVIEW

Social security benefits will generally only be taxed if an individual has other substantial income in addition to their benefits (for example, wages, self-employment, interest, dividends and other taxable income that they have to report on their tax return). No one pays taxes on more than 85 percent of his or her social security benefits and some pay on a smaller amount, based on the following IRS rules:

- ❑ If someone files a federal tax return as an "individual" and their combined incomeⁱ is between \$25,000 and \$34,000, they may have to pay income tax on 50 percent of their social security benefits. If their combined income is above \$34,000, up to 85 percent of their social security benefits is subject to income tax.
- ❑ If someone files a joint return, they may have to pay taxes on 50 percent of their benefits if they and their spouse have a combined income that is between \$32,000 and \$44,000. If their combined income is more than \$44,000, up to 85 percent of their social security benefits is subject to income tax.
- ❑ If someone is married and files a separate tax return, they will probably pay taxes on their benefits.

Every January, benefit recipients will receive a Social Security Benefit Statement (Form SSA-1099) showing the amount of benefits they have received in the previous year. Recipients can use this statement when they complete their federal income tax return to find out if any of their benefits are subject to income tax.

In applying these rules, social security benefits include monthly survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable. Although benefits recipients are not required to have federal taxes withheld from their social security benefits, some people may find it easier than paying quarterly estimated tax payments.

To find out whether any benefits may be taxable, a social security recipient should compare the base amount for their filing status (defined below) with the total of:

- ❑ One-half of their benefits, plus
- ❑ All other income, including tax-exempt interest.

ⁱ On a 1040 tax return, an individual's "combined income" is the sum of their adjusted gross income, plus nontaxable interest, plus one-half of their social security benefits.

When making this comparison, individuals do not reduce their other income by any exclusions for:

- ❑ Interest from qualified U.S. savings bonds;
- ❑ Employer-provided adoption benefits;
- ❑ Foreign earned income or foreign housing; or
- ❑ Income earned in American Samoa or Puerto Rico by bona fide residents.

An individual's base amount is:

- ❑ \$25,000 if single, head of household, or qualifying widow(er);
- ❑ \$25,000 if married filing separately and lived apart from a spouse for all of the year;
- ❑ \$32,000 if married filing jointly; or
- ❑ \$-0- if an individual is married filing separately and lived with their spouse at any time during the year.

Example:

Mark and Monica have regular income (such as interest income, dividend income, capital gain income, etc.) of \$15,000. They also have tax-exempt interest income of \$12,000. Together, they receive total social security benefits of \$20,000. Since their modified AGI (\$27,000) plus half of their social security benefits (\$10,000) exceeds the \$32,000 threshold, they will have to pay taxes on their social security benefits.

B. AMOUNT SUBJECT TO TAX

If part of an individual's benefits are taxable, how much is taxable depends on the total amount of their benefits and other income. Generally, the higher that total amount, the greater the taxable part of an individual's benefits. Generally, up to 50% of a recipient's benefits will be taxable. However, up to 85% of benefits can be taxable if either of the following situations applies:

- ❑ The total of one-half of the recipient's benefits and all their other income is more than \$34,000 (\$44,000 if married filing jointly); or
- ❑ The individual is married filing separately and lived with their spouse at any time during the year.

C. DISABILITY AND SURVIVOR BENEFITS

These tax rules also apply to social security disability and survivor benefits. Also remember that, in the case of disability and survivor benefits, many of those benefits are paid to dependent children. This means that while a parent may deposit the funds in their account and use them for the benefit of their children, they will not be treated as the parent's benefits for tax purposes.

D. WHO IS TAXED?

The person who has the legal right to receive the benefits must determine whether the benefits are taxable. For example, if a widow and her child receive benefits, but the check for the child is made out in the mother's name, the mother must use only her part of the benefits to see whether any benefits are taxable to her. One-half of the part that belongs to the child must be added to the child's other income to see whether any of those benefits are taxable to the child.

E. TAX WITHHELD AND ESTIMATED TAX

A social security beneficiary can choose to have federal income tax withheld from their benefits. To do this, an individual must complete IRS Form W-4V and choose withholding at 7%, 10%, 15%, or 25% of their total benefit payment.

If an individual does not choose to have income tax withheld, they may have to request additional withholding from other income or pay estimated tax during the year.

F. PERSONS EXEMPT FROM TAX

1. U.S. Citizens Residing Abroad

U.S. citizens who reside in the following countries are exempt from U.S. tax on their benefits:

- ☐ Canada;
- ☐ Egypt;
- ☐ Germany;
- ☐ Ireland;
- ☐ Israel;
- ☐ Italy (individual must also be a citizen of Italy for the exemption to apply); and
- ☐ Romania.

2. Lawful Permanent Residents

For U.S. income tax purposes, lawful permanent residents (green card holders) are considered resident aliens until their lawful permanent resident status under the immigration laws is either taken away or is administratively or judicially determined to have been abandoned. Social security benefits paid to a green card holder are not subject to 30% withholding.

3. Nonresident Aliens

A nonresident alien is an individual who is not a citizen or resident of the United States. If an individual is a nonresident alien, these rules do not apply. Instead, 85% of the recipient's benefits are taxed at a 30% rate, unless exempt (or subject to a lower rate) by treaty. Such recipients will receive a Form SSA-1042S or Form RRB-1042S showing the amount of their benefits. These forms will also show the tax rate and the amount of tax withheld from the recipient's benefits.

Under tax treaties with the following countries, residents of these countries are exempt from U.S. tax on their benefits:

- ❑ Canada;
- ❑ Egypt;
- ❑ Germany;
- ❑ Ireland;
- ❑ Israel;
- ❑ Italy;
- ❑ Japan;
- ❑ Romania; and
- ❑ The United Kingdom.

Under a treaty with India, benefits paid to individuals who are both residents and nationals of India are exempt from U.S. tax if the benefits are for services performed for the United States, its subdivisions, or local government authorities. If a recipient is a resident of Switzerland, their total benefit amount will be taxed at a 15% rate.

If an individual's social security benefits are exempt from tax because they are a resident of one of the treaty countries listed, the SSA will not withhold U.S. tax from their benefits.

4. Canadian or German Social Security Benefits Paid to U.S. Residents

Under income tax treaties with Canada and Germany, social security benefits paid by those countries to U.S. residents are treated for U.S. income tax purposes as if they were paid under the social security legislation of the United States.

CHAPTER 13 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. How are social security taxes distributed:
 - a) 100 percent of the money goes to pay for retiree benefits
 - b) 85 percent of the money goes to pay for retiree benefits and benefits to their families and 15 percent goes to pay for people with disabilities
 - c) 50 percent of the money goes to pay for retiree benefits and benefits to their families and 50 percent goes to pay for people with disabilities
 - d) 40 percent of the money goes to pay for retiree benefits and benefits to their families and 60 percent goes to pay for people with disabilities
2. What is the maximum number of social security credits per year that can be earned by someone who is self-employed:
 - a) one credit
 - b) two credits
 - c) four credits
 - d) six credits
3. If an individual decides to work full time beyond their full retirement age, they may lose their social security benefits.
 - a) true
 - b) false
4. A divorced spouse can receive benefits on a former husband's or wife's social security record, regardless of the length of the marriage.
 - a) true
 - b) false
5. Under what circumstances are social security retirement benefits subject to federal income tax:
 - a) never
 - b) where the recipient and his/her spouse have assets valued at \$1 million or more
 - c) when the recipient has other significant income aside from the retirement benefits
 - d) whenever the recipient or his/her spouse receives any other retirement benefits

CHAPTER 13 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. While most of the money collected goes to retirement benefits and benefits for their families, there is also some that goes toward disabled persons.

B: Correct. Social security taxes also are used to pay for administration of the entire system.

C: Incorrect. The majority of the funds goes toward retiree benefits and benefits for their family members including survivor benefits.

D: Incorrect. Most of the money goes toward retiree benefits and only a small portion goes towards disability benefits.

(See page 13-1 of the course material.)

2. A: Incorrect. Just as other workers, the maximum number of credits that can be earned each year is four.

B: Incorrect. Individuals who are employees and self-employed can earn up to four credits per year.

C: Correct. Individuals can earn one credit for every \$1,000 in earnings, capped at four credits per year.

D: Incorrect. No one can earn more than four credits per year, whether or not they are self-employed.

(See page 13-2 of the course material.)

3. A: True is incorrect. If an individual decides to work full time beyond their full retirement age, the individual can increase their social security benefits in two different ways.

B: False is correct. The individual's benefit may be increased rather than decreased. The individual's benefit can be increased either by increasing their lifetime earnings or by increasing the percentage they receive up until they begin receiving their benefits or they reach age 70.

(See page 13-4 of the course material.)

4. A: True is incorrect. The marriage must have lasted at least ten years. The divorced spouse must be 62 or older and unmarried.

B: False is correct. The divorced spouse is only entitled to the benefits if the marriage lasted at least ten years. The amount of benefits a divorced spouse gets has no effect on the amount of benefits a current spouse can receive.

(See page 13-6 of the course material.)

5. A: Incorrect. Recipients with substantial other income are subject to taxes of social security benefits, although there is a cap.

B: Incorrect. Merely having substantial assets will not trigger taxation of social security benefits; income is the key. Many people have acquired assets but do not necessarily receive income from them.

C: Correct. These people are subject to taxation of their benefits, although no more than 85 percent of those benefits can be taxed.

D: Incorrect. This is not necessarily true. It only applies if those other benefits are substantial.

(See page 13-7 of the course material.)

Part III

Income Tax Considerations in Estate And Education Planning

Chapter 14: Estate and Gift Taxes

I. Introduction

When individuals sit down to plan their estate, they are often concerned about several competing interests. On the one hand, most individuals want to minimize their tax liability during their lifetime. On the other hand, people want to leave as much property and other assets to their heirs as possible without those heirs being subject to estate or gift tax. Income tax considerations therefore play a very important role in planning an estate.

If an individual gives someone money or property during their lifetime, they may be subject to federal gift tax. The money and property an individual owns when they die (their estate) may be subject to federal estate tax. The purpose of this chapter is to provide a general understanding of when these taxes apply and when they do not. It explains how much money or property an individual can give away during their lifetime or leave to their heirs at death before any tax will be owed.

A. RECENT MAJOR CHANGES TO ESTATE AND GIFT TAXES

The Economic Growth and Tax Relief Reconciliation Act of 2001 made major changes in the tax laws, and significantly revised the federal estate and gift taxes (e.g., repeal of the estate tax, decrease in the tax rates, increase in the exclusion amount). Though the tax technically is fully repealed in 2010, the 2001 law brings back the estate and gift tax into existence in its 2001 form in 2011, unless Congress takes further action. Highlights of the 2001 changes include:

- ❑ The federal estate tax exemption amount is \$2 million in 2006 through 2008 and increases to \$3.5 million in 2009. The estate tax is fully repealed in 2010, but reinstated in 2011;
- ❑ The top federal estate tax rate dropped to 45% from 2007-2009;
- ❑ Once the estate tax is phased out, assets will not receive an automatic step-up in income tax basis at death. However, each estate will receive a \$1.3 million in basis step-up on transfers to any beneficiaries. There is also an additional \$3 million basis increase for assets transferred to a surviving spouse;
- ❑ The deduction for interests in a qualified family-owned business was repealed after 2003;
- ❑ The generation skipping transfer tax (GST) is abolished for all transfers after December 31, 2009, but is scheduled to return in 2011 and thereafter. The GST tax exemption matches the applicable estate tax exclusion amount in effect for that calendar year. The tax rate (55% in 2001) dropped to 50% in 2002 and gradually declines to 45% in 2007-2009;

- ❑ Though the estate and GST taxes are repealed in 2010, the gift tax remains. The lifetime exclusion from the gift tax, previously tied to the estate tax exemption, capped at \$1,000,000 in 2002 and will not increase thereafter to match the estate tax exemption levels. The top gift tax gradually declines from 55% in 2001 to 35% by 2010;
- ❑ Beginning in 2002-2004, the state death tax credit was reduced 25% each year and repealed in 2005. However, starting in 2005, estates may deduct state taxes from their federal returns; and
- ❑ The 5% surtax that applied to estates over \$10 million was repealed in 2002.

B. RELATIONSHIP BETWEEN ESTATE AND GIFT TAXES

Unlike most tax structures, the Estate Tax and Gift Tax are unified - integrated - into one tax system. The federal Estate and Gift Tax imposes a tax on transferring assets: one tax catches transfers made during the individual's life – the Gift Tax, the other catches transfers at death – the Estate Tax. Transfers while an individual was alive and at their death are combined and subject to one progressive tax. The rates are the same for both taxes.

There are circumstances in which a sophisticated estate planning attorney will recommend that a person make large gifts that require the payment of Gift Tax during one's lifetime. In these circumstances the impact of making the large gift and paying Gift Tax earlier results in a significantly lower Estate Tax later. In appropriate circumstances, the combined total of both the earlier Gift Tax and the later Estate Tax would be lower than the Estate Tax alone would have been, with the net effect that the person can pass on significantly higher values to his chosen beneficiaries.

C. NORMALLY NO TAX OWED

Most gifts are not subject to the gift tax and most estates are not subject to the estate tax. (Only about 2% of all estates are subject to the estate tax). For example, there is usually no tax if an individual makes a gift to his or her spouse or a qualified charity or if their estate goes to their spouse or qualified charity upon death. If an individual makes a gift to someone else, the gift tax does not apply until the value of the gifts given to that person is more than the annual exclusion for the year. Even if tax applies to a gift or estate, it may be eliminated by the Unified Credit, discussed later.

D. NO RETURN NEEDED

Generally, an individual does not need to file a gift tax return unless they give someone, other than their spouse, money or property worth more than the annual exclusion for that year. Although a return may be required, no actual gift tax will become payable until the cumulative lifetime taxable gifts exceed the applicable exclusion amount.

The donor is primarily responsible for the payment of the Gift Tax. An estate tax return generally will not be needed unless the estate is worth more than the applicable exclusion amount for the year of death. This amount is shown in the section under Unified Credit, below.

E. NO TAX ON PERSON RECEIVING GIFT OR ESTATE

The person who receives a gift or estate generally will not have to pay any gift tax or estate tax because of it. In addition, that person will not have to pay income tax on the value of the gift or inheritance received. Note, however, that there are some technical applications for "Income in Respect of Decedent" under Internal Revenue Code §691 that will have to be considered for income earned but not otherwise taxed prior to the date of death.

F. NO INCOME TAX DEDUCTION

Making a gift or leaving an estate to a decedent's heirs does not ordinarily affect federal income tax. An individual cannot deduct the value of gifts made (other than gifts that are deductible charitable contributions).

Example.

Chuck has a valuable stamp collection that has been appraised at \$10,000. He would like to give the collection to his grandson, Harold, before his death. If he chooses to make the gift, it will not be subject to gift tax because it is below the taxable threshold. However, Chuck is not entitled to take a deduction from his income tax for the value of the collection. The gift has no impact on Chuck's current tax liability whatsoever.

G. UNIFIED CREDIT

1. Application to Estate and Gift Taxes

A credit is an amount that eliminates or reduces tax. The unified credit applies to both the gift tax and the estate tax. An individual must subtract the unified credit from any gift taxes that they owe. Any unified credit that is used against an individual's gift tax in one year reduces the amount of credit that they can use against their gift tax in a later year. The total amount used against an individual's gift tax reduces the credit available to use against their estate tax.

2. Amount of Credit

For Gift Tax purposes in years 2006, 2007, and 2008 the Unified Credit is \$345,800, and the Applicable Exclusion Amount is \$1,000,000. For Estate Tax purposes in years 2006, 2007, and 2008, the Unified Credit is \$780,800 and the Applicable Exclusion Amount is \$2,000,000.

For Gift Tax purposes in year 2009 the Unified Credit is \$345,800, and the Applicable Exclusion Amount is \$1,000,000. For Estate Tax purposes in year 2009, the Unified Credit is \$1,455,800 and the Applicable Exclusion Amount is \$3,500,000.

II. Estate Taxes: An Overview

A. FORM 706

The executor of a decedent's estate uses Form 706 to figure the estate tax imposed by Chapter 11 of the Internal Revenue Code. This tax is levied on the entire taxable estate, not just on the share received by a particular beneficiary. Form 706 is also used to compute the generation-skipping transfer (GST) tax imposed by Chapter 13 on direct skips (transfers to skip persons of interests in property included in the decedent's gross estate).

B. WHICH ESTATES MUST FILE

Federal law provides an exemption from estate tax in an amount that varies from year to year. For example, for decedents who die in 2009, Form 706 must be filed by the executor for the estate of every U.S. citizen or resident whose gross estate, plus adjusted taxable gifts and specific exemption, is more than \$3,500,000. If the value of the estate is less than the applicable exemption in the decedent's year of death, no return is required. Current rules are shown in Table 14-1, below.

Table 14-1. Increased Estate Tax Applicable Exclusion Amount

An estate tax return for a U.S. citizen or resident needs to be filed only if the gross estate exceeds the applicable exclusion amount.

Applicable Exclusion Amounts	
Year	Exclusion Amount
2003	\$1,000,000
2004 and 2005	\$1,500,000
2006, 2007, 2008	\$2,000,000
2009	\$3,500,000
2010	No limit

To determine whether an executor must file a return for the estate, add:

- ☐ The adjusted taxable gifts (under § 2001(b)) made by the decedent after December 31, 1976;
- ☐ The total specific exemption allowed under § 2521 (as in effect before its repeal by the Tax Reform Act of 1976) for gifts made by the decedent after September 8, 1976; and
- ☐ The decedent's gross estate valued at the date of death.

C. GROSS ESTATE AND TAXABLE ESTATE

The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

- ❑ Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth;
- ❑ Annuities;
- ❑ The includible portion of joint estates with right of survivorship (see the instructions on the back of Schedule E);
- ❑ The includible portion of tenancies by the entirety (see the instructions on the back of Schedule E);
- ❑ Certain life insurance proceeds (even though payable to beneficiaries other than the estate) (see the instructions on the back of Schedule D);
- ❑ Property over which the decedent possessed a general power of appointment;
- ❑ Dower or curtesy (or statutory estate) of the surviving spouse; and
- ❑ Community property to the extent of the decedent's interest as defined by applicable law.

After determining the gross value of a decedent's estate, the personal representative should take all possible deductions to reduce the taxable estate. These deductions include:

- ❑ Funeral expenses paid out of the decedent's estate;
- ❑ Debts the decedent owed at the time of death; and
- ❑ The marital deduction (generally, the value of the property that passes from the decedent's estate to their surviving spouse).

D. ADMINISTRATIVE EXPENSES

Expenses of administering an estate can be deducted from the gross estate in figuring the federal estate tax.

1. Typical Expenses

In general, administration expenses deductible in figuring the estate tax include:

- ❑ Fees paid to the fiduciary for administering the estate;
- ❑ Attorney, accountant, and return preparer fees;
- ❑ Expenses incurred for the management, conservation, or maintenance of property; and

- ❑ Expenses in connection with the determination, collection, or refund of the estate's tax liability.

2. No Double Dipping

Administrative expenses cannot be claimed for both estate tax and income tax purposes. The expenses incurred in the sale of property are deductible from the gross estate only if the sale was necessary to pay decedent debts, or to preserve or distribute the property of the estate.

E. MARITAL DEDUCTION

One of the primary deductions for married decedents is the Marital Deduction. All property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction. The property must pass "outright." In some cases, certain life estates also qualify for the marital deduction.

F. CHARITABLE DEDUCTION

If the decedent leaves property to a qualifying charity either during his or her life or at death, it is deductible from the gross estate. Potential donors must be sure the "charity" they are considering qualifies for tax purposes.

Generally, only the five following types of organizations can be qualified organizations:

- ❑ A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must be organized and operated only for one or more of the following purposes:
 - Religious;
 - Charitable;
 - Educational;
 - Scientific;
 - Literary; or
 - The prevention of cruelty to children or animals.

Certain organizations that foster national or international amateur sports competition also qualify;

- ❑ War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions;

- ❑ Domestic fraternal societies, orders, and associations operating under the lodge system (note that contribution to this type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals);
- ❑ Certain nonprofit cemetery companies or corporations (note that a contribution to this type of organization is not deductible if it can be used for the care of a specific lot or mausoleum crypt); and
- ❑ The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions (note that to be deductible, a contribution to this type of organization must be made solely for public purposes).

Example 1.

Ozzie contributes cash to his city's police department to be used as a reward for information about a crime. The city police department is a qualified organization, and his contribution is for a public purpose. He can deduct his contribution.

Example 2.

Sharon makes a voluntary contribution to the social security trust fund, not earmarked for a specific account. Because the trust fund is part of the U.S. Government, she contributed to a qualified organization. She can deduct her contribution.

The following list gives some examples of qualified organizations:

- ❑ Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations;
- ❑ Most nonprofit charitable organizations such as the Red Cross and the United Way;
- ❑ Most nonprofit educational organizations, including the Boy (and Girl) Scouts of America, colleges, museums, and day-care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution;
- ❑ Nonprofit hospitals and medical research organizations;
- ❑ Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs;

- ❑ Nonprofit volunteer fire companies;
- ❑ Public parks and recreation facilities; and
- ❑ Civil defense organizations.

1. Giving Property That Has Decreased in Value

One of the more technical areas of charitable giving involves gifts of property that have decreased in value. If an individual contributes property with a fair market value that is less than their basis in it, the deduction is limited to its fair market value. An individual cannot claim a deduction for the difference between the property's basis and its fair market value. Common examples of property that decrease in value include clothing, furniture, appliances, and cars.

2. Giving Property That Has Increased in Value

Another common estate planning tool involves the gift of property that has appreciated in value. If an individual contributes property with a fair market value that is more than their basis in it, they may have to reduce the fair market value by the amount of appreciation (increase in value) when calculating their deduction.

Different rules apply to figuring the deduction, depending on whether the property is ordinary income property or capital gain property.

Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held 1 year or less.

Property used in a trade or business is considered ordinary income property to the extent of any gain that would have been treated as ordinary income because of depreciation had the property been sold at its fair market value at the time of contribution.

The amount an individual can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if the owner sold the property for its fair market value. Generally, this rule limits the deduction to the owner's basis in the property.

Example.

Lonnie, who knows he has only six months to live, donates stock that he has held for 5 months to his church. The fair market value of the stock on the day he donates it is \$1,000, but he paid only \$800 (his basis). Because the \$200 of appreciation would be short-term capital gain if Lonnie sold the stock, his deduction is limited to \$800 (fair market value less the appreciation).

Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. Capital gain property includes capital assets held more than one year.

Capital assets include most items of property that an individual owns and uses for personal purposes or investment. Examples of capital assets are stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes. For purposes of figuring a charitable contribution, capital assets also include certain real property and depreciable property used in a trade or business and, generally, held more than one year. (Individuals may have to treat this property as partly ordinary income property and partly capital gain property.)

When figuring the deduction for a gift of capital gain property, an individual can usually use the fair market value of the gift. However, in certain situations, they must reduce the fair market value by any amount that would have been long-term capital gain if the individual had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis. This must be done if:

- ❑ The property (other than qualified appreciated stock) is contributed to certain private non-operating foundations;
- ❑ The contributed property is tangible personal property that is put to an unrelated use by the charity; or
- ❑ The individual chooses the 50% limit instead of the 30% limit, discussed later.

The reduced deduction applies to contributions to all private non-operating foundations other than those qualifying for the 50% limit, discussed later.

However, the reduced deduction does not apply to contributions of qualified appreciated stock. Qualified appreciated stock is any stock in a corporation that is capital gain property and for which market quotations are readily available on an established securities market on the day of the contribution. But stock in a corporation does not count as qualified appreciated stock to the extent the individual and their family contributed more than 10% of the value of all the outstanding stock in the corporation.

The term tangible personal property means any property, other than land or buildings, that can be seen or touched. It includes furniture, books, jewelry, paintings, and cars. The term unrelated use means a use that is unrelated to the exempt purpose or function of the charitable organization. For a governmental unit, it means the use of the contributed property for other than exclusively public purposes.

Example.

If a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use. But if the painting is sold and the proceeds are used by the organization for educational purposes, the use is an unrelated use.

An individual should not reduce his charitable contribution if he includes the ordinary or capital gain income in his gross income in the same year as the contribution. This may happen when an individual transfers installment or discount obligations or when they assign income to a charitable organization.

Example.

Ray donates an installment note to a qualified organization. The note has a fair market value of \$10,000 and a basis to Ray of \$7,000. As a result of the donation, Ray has a short-term capital gain of \$3,000 (\$10,000 - \$7,000), which he includes in his income for the year. Ray's charitable contribution is \$10,000.

3. Bargain Sales

A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. The part of the bargain sale that is a sale or exchange may result in a taxable gain.

The part that is a charitable contribution is calculated in three steps:

Step 1. Subtract the amount the individual received for the property from the property's fair market value at the time of sale. This gives the fair market value of the contributed part.

Step 2. Find the adjusted basis of the contributed part. It equals: Adjusted basis of entire property x fair market value of contributed part ÷ fair market value of entire property.

Step 3. Determine whether the amount of the charitable contribution is the fair market value of the contributed part (which was found in *Step 1*) or the adjusted basis of the contributed part (which was found in *Step 2*). Generally, if the property sold was capital gain property, the charitable contribution is the fair market value of the contributed part. If it was ordinary income property, the charitable contribution is the adjusted basis of the contributed part.

Example.

Bernard sells ordinary income property with a fair market value of \$10,000 to a church for \$2,000. Bernard's basis is \$4,000 and his adjusted gross income is \$20,000. Bernard makes no other contributions during the year. The fair market value of the contributed part of the property is \$8,000 (\$10,000 - \$2,000). The adjusted basis of the contributed part is \$3,200 ($\$4,000 \times (\$8,000 \div \$10,000)$). Because the property is ordinary income property, Bernard's charitable contribution deduction is limited to the adjusted basis of the contributed part. He can deduct \$3,200.

4. Limits on Deductions

If an individual's total contributions for the year are 20% or less of their adjusted gross income, this section does not apply. However, for someone considering making large contributions to reduce the size of their taxable estate, the following rules are very important. The amount of an individual's deduction is limited to 50% of their adjusted gross income, and may be limited to 30% or 20% of their adjusted gross income, depending on the type of property donated and the type of organization to which it is given.

a. 50% Limit

The 50% limit applies to the total of all charitable contributions made during the year. This means that an individual's deduction for charitable contributions cannot be more than 50% of their adjusted gross income for the year.

The 50% limit is the only limit that applies to gifts to organizations listed below under 50% Limit Organizations. But there is one exception. A 30% limit also applies to these gifts if they are gifts of capital gain property for which an individual figures their deduction using fair market value without reduction for appreciation.

b. 50% Limit Organizations

Only the following types of organizations are 50% limit organizations:

- ☐ Churches, and conventions or associations of churches;
- ☐ Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site;
- ☐ Hospitals and certain medical research organizations associated with these hospitals;

- ❑ Organizations that are operated only to receive, hold, invest, and administer property and to make expenditures to or for the benefit of state and municipal colleges and universities and that normally receive substantial support from the United States or any state or their political subdivisions, or from the general public;
- ❑ The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions;
- ❑ Corporations, trusts, or community chests, funds, or foundations organized and operated only for charitable, religious, educational, scientific, or literary purposes, or to prevent cruelty to children or animals, or to foster certain national or international amateur sports competition. These organizations must be “publicly supported,” which means they normally must receive a substantial part of their support, other than income from their exempt activities, from direct or indirect contributions from the general public or from governmental units;
- ❑ Organizations that may not qualify as “publicly supported” but that meet other tests showing they respond to the needs of the general public, not a limited number of donors or other persons. They must normally receive more than one-third of their support either from organizations described in above or from persons other than “disqualified persons”;
- ❑ Most organizations operated or controlled by and operated for the benefit of those organizations described above;
- ❑ Private operating foundations;
- ❑ Private non-operating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution. A deduction for charitable contributions to any of these private non-operating foundations must be supported by evidence from the foundation confirming that it made the qualifying distributions timely. A copy of this supporting data should be attached to the tax return; and
- ❑ A private foundation whose contributions are pooled into a common fund, if the foundation would be described above but for the right of substantial contributors to name the public charities that receive contributions from the fund. The foundation must distribute the common fund's income within 2½ months following the tax year in which it was realized and must distribute the corpus not later than 1 year after the donor's death (or after the death of the donor's surviving spouse if the spouse can name the recipients of the corpus).

c. 30% Limit

A 30% limit applies to the following gifts:

- ❑ Gifts to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private non-operating foundations; and
- ❑ Gifts for the use of any organization.

However, if these gifts are of capital gain property, they are subject to the 20% limit, described later, rather than the 30% limit.

d. Special 30% Limit for Capital Gain Property

A special 30% limit applies to gifts of capital gain property to 50% limit organizations. However, the special 30% limit does not apply when an individual chooses to reduce the fair market value of the property by the amount that would have been long-term capital gain if they had sold the property. Instead, only the 50% limit applies.

This special 30% limit for capital gain property is separate from the other 30% limit. Therefore, the deduction of a contribution subject to one 30% limit does not reduce the amount an individual can deduct for contributions subject to the other 30% limit. However, the total an individual can deduct cannot be more than 50% of their adjusted gross income.

Example.

Paul's adjusted gross income is \$50,000. During the year, he gave capital gain property with a fair market value of \$15,000 to a 50% limit organization. Paul does not choose to reduce the property's fair market value by its appreciation in value. He also gave \$10,000 cash to a qualified organization that is not a 50% limit organization. The \$15,000 gift of property is subject to the special 30% limit. The \$10,000 cash gift is subject to the other 30% limit. Both gifts are fully deductible because neither is more than the 30% limit that applies (\$15,000 in each case) and together they are not more than the 50% limit (\$25,000).

e. 20% Limit

The 20% limit applies to all gifts of capital gain property to or for the use of qualified organizations (other than gifts of capital gain property to 50% limit organizations).

f. Calculating a Deduction When Limits Apply

If an individual's contributions are subject to more than one of the limits just discussed, they can deduct them as follows:

1. Contributions subject only to the 50% limit, up to 50% of an individual's adjusted gross income.

2. Contributions subject to the 30% limit, up to the lesser of:
 - a. 30% of adjusted gross income, or
 - b. 50% of adjusted gross income minus an individual's contributions to 50% limit organizations, including contributions of capital gain property subject to the special 30% limit.
3. Contributions of capital gain property subject to the special 30% limit, up to the lesser of:
 - a. 30% of adjusted gross income, or
 - b. 50% of adjusted gross income minus an individual's other contributions to 50% limit organizations.
4. Contributions subject to the 20% limit, up to the lesser of:
 - a. 20% of adjusted gross income,
 - b. 30% of adjusted gross income minus an individual's contributions subject to the 30% limit,
 - c. 30% of adjusted gross income minus an individual's contributions of capital gain property subject to the special 30% limit, or
 - d. 50% of adjusted gross income minus the total of an individual's contributions to 50% limit organizations and their contributions subject to the 30% limit.

Example.

Martha's adjusted gross income is \$50,000. During the year, she gave her church \$2,000 cash and land with a fair market value of \$28,000 and a basis of \$22,000. Martha held the land for investment purposes. She does not choose to reduce the fair market value of the land by the appreciation in value. Martha also gave \$5,000 cash to a private foundation to which the 30% limit applies.

The \$2,000 cash donated to the church is considered first and is fully deductible. Her contribution to the private foundation is considered next. Because her contributions to 50% limit organizations (\$2,000 + \$28,000) are more than \$25,000 (50% of \$50,000), her contribution to the private foundation is not deductible for the year. It can be carried over to later years. The gift of land is considered next. Martha's deduction for the land is limited to \$15,000 (30% × \$50,000). The unused part of the gift of land (\$13,000) can be carried over. For this year, Martha's deduction is limited to \$17,000 (\$2,000 + \$15,000).

g. Capital Gain Property Election

An individual may choose the 50% limit for gifts of capital gain property to 50% limit organizations instead of the 30% limit that would otherwise apply. If an individual makes this choice, they must reduce the fair market value of the property contributed by the appreciation in value that would have been long-term capital gain if the property had been sold. This choice applies to all capital gain property contributed to 50% limit organizations during a tax year. It also applies to carryovers of this kind of contribution from an earlier tax year.

An individual must make the choice on their original return or on an amended return filed by the due date for filing the original return.

Example.

In the previous example, if Martha chose to have the 50% limit apply to the land (the 30% capital gain property) given to her church, she must reduce the fair market value of the property by the appreciation in value. Therefore, the amount of her charitable contribution for the land would be its basis to her of \$22,000. Martha adds this amount to the \$2,000 cash contributed to the church. She can now deduct \$1,000 of the amount donated to the private foundation because her contributions to 50% limit organizations (\$2,000 + \$22,000) are \$1,000 less than the 50%-of-adjusted-gross-income limit. Her total deduction for the year is \$25,000 (\$2,000 cash to her church, \$22,000 for property donated to her church, and \$1,000 cash to the private foundation). Martha can carry over to later years the part of her contribution to the private foundation that she could not deduct (\$4,000).

h. Carryovers

An individual can carry over their contributions that they are not able to deduct in the current year because they exceed their adjusted-gross-income limits. The individual can deduct the excess in each of the next 5 years until it is used up, but not beyond that time. Their total contributions deduction for the year to which they carry their contributions cannot exceed 50% of their adjusted gross income for that year.

Contributions an individual carries over are subject to the same percentage limits in the year to which they are carried. For example, contributions subject to the 20% limit in the year in which they are made are 20% limit contributions in the year to which they are carried.

For each category of contributions, an individual can deduct carryover contributions only after deducting all allowable contributions in that category for the current year. If an individual has carryovers from two or more prior years, they must use the carryover from the earlier year first.

Also note that a carryover of a contribution to a 50% limit organization must be used before contributions in the current year to organizations other than 50% limit organizations.

G. VALUING AN ESTATE

As a general rule, every asset included in a decedent's gross estate is valued at its fair market value. The personal representative can choose from the following valuation dates:

- ❑ The decedent's date of death; or
- ❑ The value six months later (known as the alternate valuation date).

The alternative valuation date election is allowed only if it lowers the individual's tax liability. Whatever date is selected, it is irrevocable and will apply to all assets in the estate.

If the 6-months-after-death date applies, all of the decedent's assets must be valued on that date. Furthermore, if property is sold, distributed, exchanged, or disposed of during the 6-month period, it is valued on the date of the distribution, sale, etc., rather than the alternative valuation date.

Family farmland and closely-held family business interests can be valued at less than their highest-and-best use. It is important that the decedent's personal representative accurately value the estate. Otherwise, underpayment penalties described below apply.

H. U.S. CITIZENS OR RESIDENTS; NONRESIDENT NONCITIZENS

An executor must file Form 706 for the estates of decedents who were either U.S. citizens or U.S. residents at the time of death. For estate tax purposes, a resident is someone who had a domicile in the United States at the time of death. A person acquires a domicile by living in a place for even a brief period of time, as long as the person had no intention of moving from that place.

An executor must file Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States, for the estates of nonresident alien decedents (decedents who were neither U.S. citizens nor residents at the time of death).

I. PAYING ESTATE TAXES

The estate and Generation Skipping Taxes (GST) taxes are due within 9 months after the date of the decedent's death unless an extension of time for payment has been granted, or unless an executor has properly elected under § 6166 to pay in installments, or under § 6163 to postpone the part of the tax attributable to a reversionary or remainder interest.

J. PENALTIES

1. Late Filing and Late Payment

Internal Revenue Code § 6651 provides for penalties for both late filing and for late payment unless there is reasonable cause for the delay. The law also provides for penalties for willful attempts to evade payment of tax. The late filing penalty will not be imposed if the taxpayer can show that the failure to file a timely return is due to reasonable cause.

2. Valuation Understatement

Internal Revenue Code § 6662 provides a 20% penalty for the underpayment of estate tax that exceeds \$5,000 when the underpayment is attributable to valuation understatements. A valuation understatement occurs when the value of property reported on Form 706 is 50% (65% for returns filed after 8/17/06) or less of the actual value of the property.

This penalty increases to 40% if there is a gross valuation understatement. A gross valuation understatement occurs if any property on the return is valued at 25% (40% for returns filed after 8/17/06) or less of the value determined to be correct.

These penalties also apply to late filing, late payment, and underpayment of GST taxes.

III. Gift Tax

The gift tax applies to the transfer by gift of any property. An individual makes a gift if they give property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. If an individual sells something at less than its full value or if they make an interest-free or reduced interest loan, they may be making a gift.

Example 1.

Lisa's granddaughter, Katie, is going away to college and needs a car to come home on the weekends. Lisa buys Katie a Volkswagen Bug. This is clearly a gift.

Example 2.

Rob's cousin, Mark, is trying to open a new business detailing cars. Rob has always felt that Mark did not get as much financial support from their grandparents as he did so he wants to help his cousin out. He tells Mark that he will "loan" him \$50,000 to open his business, but that the money does not need to be paid back until the business becomes successful. Although Rob is calling this payment a "loan," it appears more like a gift since there is no apparent expectation of repayment.

Even if tax applies to a gift or estate, it may be eliminated by the Unified Credit, discussed below.

A. GENERAL RULE

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, the following gifts are not taxable gifts:

- ❑ Gifts that are not more than the annual exclusion for the calendar year;
- ❑ Tuition or medical expenses a taxpayer pays for someone (the educational and medical exclusions);

- ❑ Gifts to an individual's spouse;
- ❑ Gifts to a political organization for its use; and
- ❑ Gifts to qualified charities (a deduction is available for these amounts).

B. ANNUAL EXCLUSION

A separate annual exclusion applies to each person to whom an individual makes a gift. For 2008, the annual exclusion was \$12,000. Therefore, during 2008 an individual generally could give up to \$12,000 each to any number of people and none of the gifts would have been taxable.

1. Married Couples

If an individual is married, both they and their spouse can separately give up to \$12,000 to the same person in the same year without making a taxable gift. If one of the two gives more than \$12,000 to a person, the gift splitting rules discussed below apply. Gifts to individuals are not deductible on the donor's income tax returns.

2. Inflation Adjustment

After 2009, the \$12,000 annual exclusion is increased due to a cost-of-living adjustment to \$13,000. See the instructions for Form 709 for the amount of the annual exclusion for the year the gift is made.

Example 1.

In 2008, Wanda gives her niece a cash gift of \$8,000. It is her only gift to her this year. The gift is not a taxable gift because it is not more than the \$12,000 annual exclusion.

Example 2.

Martin pays the \$15,000 college tuition of his friend. Because the payment qualifies for the educational exclusion, the gift is not a taxable gift.

Example 3.

In 2008, Ken gives \$25,000 to his 25-year-old daughter. The first \$12,000 of his gift is not subject to the gift tax because of the annual exclusion. The remaining \$13,000 is a taxable gift. As explained later under Applying the Unified Credit to Gift Tax, Ken may not have to pay the gift tax on the remaining \$13,000. However, he does have to file a gift tax return.

3. Gift Splitting

If an individual and his spouse make a gift to a third party, the gift can be considered as made one-half by the individual and one-half by his spouse. This is known as *gift splitting*. Both spouses must consent (agree) to split the gift. If such consent is given, each spouse can take the annual exclusion for their part of the gift. In 2008, for example, gift splitting allowed married couples to give up to \$24,000 to a person without making a taxable gift.

If a couple does decide to split a gift, they must file a gift tax return showing that there was an agreement to split the gift.

Example.

John and his wife, Marsha, agree to split the gifts that they made during 2008. John gives his son, George, \$21,000, and Marsha gives her daughter, Gina, \$18,000. Although each gift is more than the annual exclusion (\$12,000), by gift splitting they can make these gifts without making a taxable gift.

John's gift to George is treated as one-half (\$10,500) from John and one-half (\$10,500) from Marsha. Marsha's gift to Gina is also treated as one-half (\$9,000) from Marsha and one-half (\$9,000) from John. In each case, because one-half of the split gift is not more than the annual exclusion, it is not a taxable gift. However, each of them must file a gift tax return.

4. No Limit on Number of Gift Recipients

An individual is free to give away as many gifts as they want. In theory, a rich man could dispose of his entire estate by giving thousands of people a gift that falls under the annual exclusion level.

Example.

Walt, who knows that he is dying, decides to dispose of his entire \$1,000,000 cash estate by making gifts to his many family members and friends. Assuming the applicable annual exclusion in the year he wishes to make the gifts is \$12,000, Walt can make a gift of \$12,000 to 83 different people and \$4,000 to one person and avoid any gift tax liability. In so doing, he will be disposing of his entire \$1,000,000 in a single year.

C. APPLICATION OF THE UNIFIED CREDIT

A credit is an amount that eliminates or reduces tax. The unified credit applies to both the gift tax and the estate tax. An individual must subtract the unified credit from any gift tax that they owe. Any unified credit used against the gift tax in one year reduces the amount of credit that can be used against gift tax in a later year. The total amount used against gift tax reduces the credit available to use against estate tax.

Example.

In 2008, Lori gave her niece, Mary, a cash gift of \$8,000. It was her only gift to her this year. Lori pays the \$15,000 college tuition of her friend, David. Lori gave her 25-year-old daughter, Lisa, \$26,000. She also gave her 27-year-old son, Ken, \$26,000. Before 2008, Lori had never given a taxable gift. She applies the exclusions to the gift tax and the unified credit as follows:

- 1. Apply the educational exclusion. Payment of tuition expenses is not subject to the gift tax. Therefore, the gift to David is not a taxable gift.*
- 2. Apply the annual exclusion. The first \$12,000 given to someone during 2008 is not a taxable gift. Therefore, her \$8,000 gift to Mary, the first \$12,000 of her gift to Lisa, and the first \$12,000 of her gift to Ken are not taxable gifts.*
- 3. Apply the unified credit. The gift tax on \$28,000 (\$14,000 remaining from her gift to Lisa plus \$14,000 remaining from her gift to Ken) is \$5,560. Lori subtracts the \$5,560 from her unified credit of \$345,800 for 2008. The unified credit that she can use against the gift tax in a later year is \$340,240.*

Lori does not have to pay any gift tax for 2008. However, she does have to file Form 709.

D. GIFTS EXEMPT FROM TAX

Regardless of the identity of the recipient or the purpose of the gift (i.e. to help pay for a car or to take a Caribbean cruise), any gift which falls under the annual exclusion limit is exempt from tax. There are other categories that provide a larger exemption.

1. Educational and Medical Expenses

In addition to the \$12,000 annual Gift Tax exclusion, there is a 100% exclusion when an individual makes direct payments for someone's medical bills or tuition expenses. Both the medical and educational exclusions are allowed without regard to the relationship – so the recipient need not be a close relative or dependent. The payments must be made directly to the medical care provider or the educational institution. Payments to the recipient cancel the tax benefit. Room and board, supplies, books and other fees do not qualify.

A qualifying educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students.

Medical care includes expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, or for transportation. It also includes medical insurance.

2. Gifts to a Spouse

Transfers between spouses are 100% deductible for gift tax purposes. This is known as the "unlimited Gift Tax marital deduction". However, the value of the gift, whether it was for a future or present interest, must be included in the giver's gross estate on death in order for the deduction to apply. If the gross estate does not include the transfers to the spouse, no marital deduction applies.

This gift exclusion only applies to gifts to a U.S. citizen spouse. An individual can give away \$125,000 in 2008 (\$133,000 in 2009) tax-free to a spouse who is not a U.S. citizen.

3. Charitable Contributions

Individuals can give any amount – no matter how large – to a qualified charity completely tax-free. For example, if Martin owns real estate that he gifts outright to a charity, no gift tax is due. The value of what Martin transferred is included in the gross estate after his death, but it is 100% subtracted before the tax rates are applied. This issue is discussed in more detail above in the section on estate taxes.

E. VALUING GIFTS

An important component in determining the applicability of a gift tax is the value of the gift. If someone makes a gift of \$15,000 in cash, valuation is obviously not an issue. Valuation questions arise with other types of property, such as real property, stocks and collectibles.

Example.

Michael makes a gift to his nephew of 1,000 shares of stock in XYZ Corporation. Michael purchased the shares two years ago at \$5 per share. On the day he makes the gift, the stock is trading at \$15 per share. Is the value of the gift \$5,000 (the amount Michael paid for the stock) or \$15,000 (the current value of the stock at the time the gift is executed)? The IRS considers the value of the gift to be its fair market value at the time the gift is made. This means that the value of this gift is \$15,000, above the applicable annual exclusion of \$12,000. The gift will still, however, come under Michael's lifetime umbrella exclusion and he will therefore not currently have to pay tax on the gift. Upon Michael's death, the total amount of his lifetime gifts will be calculated and subtracted from his unified credit applicable in the year of his death.

Table 14-2. Determining Whether Gift Is Subject to Gift Tax

The following table is intended to help the reader determine whether a gift is subject to gift tax or not.

Type of Gift	Whether It Is Subject to Gift Tax
Father gives 10 gifts of \$2,000 each to his son during calendar year.	Yes. Total of gifts during year exceed annual exclusion level.
Mother gifts her remainder interest in her mother's life estate to her daughter.	Yes. Future interests are always subject to gift tax, regardless of value.
Husband gives his wife a \$25,000 diamond ring to celebrate their silver wedding anniversary.	No. Gift to spouse is exempt regardless of value.
Uncle pays the \$15,000 annual tuition for his nephew to attend a private university.	No. Educational expenses are normally exempt.
Grandmother pays \$20,000 for surgery for grandson who does not have medical insurance.	No. Medical expenses are normally exempt.
Husband and wife jointly donate \$1,000,000 to cancer research at the UCLA medical center.	No. Gift is made to a charitable organization.

F. FILING A GIFT TAX RETURN

As with the income tax return, Gift Tax returns (Form 709) are due on April 15 of the year following the year in which the taxpayer made the gift. The Gift Tax (if any) is due at the time of filing the return.

1. Return Required

An individual must file a gift tax return on Form 709 if any of the following apply:

- ☐ They gave gifts that are more than the annual exclusion for the year to someone (other than their spouse);
- ☐ An individual and their spouse are splitting a gift (discussed above);
- ☐ An individual gave someone (other than his or her spouse) a gift that he or she cannot actually possess, enjoy, or receive income from until some time in the future; or
- ☐ An individual gave his or her spouse an interest in property that will be ended by some future event.

2. Return Not Required

An individual is not required to file a gift tax return to report gifts to (or for the use of) political organizations and gifts made by paying someone's tuition or medical expenses. An individual also does not need to report the following deductible gifts made to charities:

- ❑ Their entire interest in property, if no other interest has been transferred for less than adequate consideration or for other than a charitable use; or
- ❑ A qualified conservation contribution that is a restriction (granted forever) on the use of real property.

IV. Generation Skipping Tax

A. APPLICATION AND RATIONALE

The generation skipping tax sounds complicated but in reality it is a simple concept intended to prevent families from avoiding estate taxes.

Example.

Roger is an 85-year-old widower with one son and five grandchildren. Roger's son, Jason, is 62-years-old and is suffering from advanced prostate cancer. He is also financially secure. If Roger leaves his property to his son, it will likely soon pass to his grandchildren. If this happens, it may be subject to estate taxes when it is passes to Jason and then again when Jason dies and leaves the estate to his own children. In order to avoid the potential of double taxation, Roger elects to "skip" his son's generation and leave his estate directly to his grandchildren. While the idea may seem sound, the generation skipping tax could kick in and eliminate his planned tax savings.

The generation skipping tax (hereinafter referred to as "GST") can apply outside of familial situations as well. It may be due if a beneficiary of a gift or estate is 37.5 years younger than the donor or deceased.

1. Assignment to Generations

A GST tax is due when a transfer of assets is made to a "skip person." A skip person is determined by looking at the generation assignments applicable for family and non-family members.

a. Family Members

Generally, the GST tax will be imposed when the assets are transferred to a family member two or more generations below the decedent or person making the gift. The family member must be a lineal descendant of the transferor's, or his or her spouse's, grandparents. For example, a grand-nephew, grandson or spouse's grand-nephew would all be classified as two generations below the transferor.

The law does not distinguish between persons who are whole-blood, half-blood or adopted relatives. Regardless of the age difference between spouses, they are always considered to be of the same generation.

b. Predeceased Generation in a Direct Skip

This rule allows someone from a lower generation to be pushed into a higher generation if they were predeceased by someone from that higher generation.

Example.

Lucy leaves her property in trust to her son for his life, and upon her son's death, to her grandson. If her son dies before Lucy, the property that passes to her grandson will not be considered to have skipped a generation.

A living descendant who dies no later than 90 days after the subject transfer is treated as having predeceased the transferor to the extent that either the governing instrument or applicable local law provides that such individual shall be treated as predeceasing the transferor.

In most cases, a living descendant is not treated as a predeceased child solely by reason of applicable local law; e.g., an individual is not treated as a predeceased child solely because state law treats an individual executing a disclaimer as having predeceased the transferor of the disclaimed property.

Example 1.

Thomas establishes an irrevocable trust providing that trust income is to be paid to Thomas' grandchild, Sam, for 5 years. At the end of the 5-year period, the trust is to terminate and the principal is to be distributed to Sam. Thomas's child, Charles, a parent of Sam, is deceased at the time Thomas establishes the trust. Therefore, Sam is treated as a child of Thomas rather than as a grandchild. As a result, Sam is not a skip person, and the initial transfer to the trust is not a direct skip. Similarly, distributions to Sam during the term of the trust and at the termination of the trust will not be GSTs.

Example 2.

The facts are the same as in Example 1, except the trust income is to be paid to Thomas's spouse, Sylvia, during the first two years of the trust. Since Sylvia has an interest in the trust, the trust is not a skip person and the transfer by Thomas is not a direct skip. Since the transfer is not a direct skip, the predeceased ancestor rule does not apply and Sam is not treated as the child of Thomas. A taxable termination occurs at the expiration of Sylvia's interest.

c. Non-Family Situations

Non-family members are assigned to the same generation if the individual making the gift and the recipient are within 12½ years of each other in age. A beneficiary with an age difference from the person making the gift of between 12½ and 37½ years is assigned to the second generation. Any transfer of property between individuals with an age difference of more than 37½ years is subject to GST tax. Individuals with an age difference of more than 37½ years are assigned to generations in 25-year increments.

B. EXEMPTIONS

1. Life Time Exemption

Individuals may avoid the impact of the GST through their applicable lifetime exemption. The exemption is \$3,500,000 for 2009 and is set to expire in 2010 barring Congressional action. Application of the exemption can have a profound tax savings affect on an estate.

Example.

Lorraine plans to gift \$1.12 million to a trust to provide income to her son and grandchildren. She allocates all of her GST exemption to the transfer. Because all of Lorraine's property placed in the trust is permanently exempt from GST tax, neither the principal in the trust nor proceeds paid to her son or grandchildren will be subject to tax. If, on the other hand, Lorraine had not used her GST exemption and her son were to die, the \$1.12 million that would pass to her grandchildren would be subject to the GST. Assuming a tax rate of 55%, that would reduce the value of the estate to \$504,000.

2. Gifts

Gifts given outright that qualify for the applicable Gift Tax exclusion are shielded from the GST tax as are education and medical expenses.

3. Allocation of Exemption

The exemption may be allocated to the transferred property at any time before an estate tax return becomes due. Once the allocation election is made, the decision is irrevocable.

4. Unused Exemption

Unused GST credit is automatically allocated to direct skip transfers made during the life of a decedent unless the person elects otherwise on a gift tax return. In addition, the exemption will be deemed allocated to any trust that involves an "indirect skip" during the decedent's lifetime.

Any portion of the exemption that remains unallocated upon the death of the decedent is first allocated to any direct skips that occur at his or her death (e.g. a bequest to a grandchild), and then to trusts from which a taxable distribution or taxable termination may occur by virtue of the individual's death. A generation-skipping trust may undergo a "qualified severance" under which it would be split into exempt and non-exempt trusts.

C. TAX RATE

The GST has been repealed effective 2010 but reapplies in its entirety as of 2011. Until 2010, the exemption amount will be the same as the estate tax exemption amount.

The GST is currently a 45% tax that may be due in addition to any Estate Tax.

Table 14-3. Generation Skipping Tax Rate

Year	Rate
2006	46%
2007-2009	45%
2010	Repealed for One-Year Only
2011	55%

1. Tax Rate Is Flat

Unlike the graduated tax rates used for the estate and gift taxes, the GST tax is a flat rate tax.

2. State Tax Credit

The federal GST tax permits a credit for any GST taxes paid to a state. The credit may only be claimed if:

- ☐ The transfer is not a direct skip; and
- ☐ The GST occurs at the same time and as a result of the death of an individual.

The amount allowed as a credit must not surpass 5% of the amount of the federal GST tax imposed.

The Economic Growth and Tax Relief Reconciliation Act of 2001 eliminates the federal credit for state GST taxes paid for the years 2005-2009. The federal credit will be reinstated in 2011 when the federal GST returns.

3. Deductions

In some cases, deductions are available to reduce the liability of the GST tax. The type of transfer determines whether a deduction applies. The transferor of a taxable termination may claim a deduction for administration expenses, indebtedness and taxes. Taxable distributions may be reduced by the expenses of determination, collection, or refund of a tax. Direct skips, on the other hand, are not eligible for any deductions.

D. PAYMENT OF TAX

The party responsible for payment of the GST tax depends upon the type of generation skipping transfer. The following table identifies which individual must pay the GST tax.

Table 14-4. Payment of Generation Skipping Tax

Type of Transfer	Party Responsible for Paying Tax
Taxable Termination	Trustee
Taxable Distribution	Transferee
Direct Skip (Trust)	Trustee
Direct Skip (Outright Transfer)	Transferor

1. Taxable Termination

A "taxable termination" occurs upon the termination of an interest in property held in trust (by death, lapse of time, release of power, or otherwise) if:

- ☐ Immediately after the termination a skip person has an interest in such property; or
- ☐ At any time after the termination, a distribution may be made from the trust to a skip person.

A common example of a taxable termination occurs when a decedent places assets in a trust, with income payable for life to a child, and the remainder to a grandchild. Normally, the child's life estate interest would not be taxable at death. However, the GST treats the termination of the child's interest at death as a "taxable termination," i.e. a taxable transfer to the grandchild, triggering the tax.

Example 1.

Allan establishes an irrevocable trust under which the income is to be paid to his child, Chris, for life. On the death of Chris, the trust principal is to be paid to Allan's grandchild, Alex. Since Chris has an interest in the trust, the trust is not a skip person and the transfer to the trust is not a direct skip. If Chris dies survived by Alex, a taxable termination occurs at Chris's death because Chris's interest in the trust terminates and thereafter the trust property is held by a skip person who occupies a lower generation than Chris.

Example 2.

Allan establishes an irrevocable trust for the benefit of his child, Chris, grandchild, Alex, and Allan's great-grandchild, Lisa. Under the terms of the trust, income and principal may be distributed to any or all of the living beneficiaries at the discretion of the trustee. Upon the death of the second beneficiary to die, the trust principal is to be paid to the survivor. Chris dies first. A taxable termination occurs at that time because, immediately after Chris's interest terminates, all interests in the trust are held by skip persons (Alex and Lisa).

2. Taxable Distribution

A "taxable distribution" is a distribution from a trust to a "skip person" that is not classified as a taxable termination or a direct skip.

3. Direct Skip

A direct skip is a transfer to a skip person that is subject to Federal estate or gift tax. If property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person. Only one direct skip occurs when a single transfer of property skips two or more generations.

Example 1.

Ted gratuitously conveys Blackacre to Ted's grandchild. Because the transfer is a transfer to a skip person of property subject to Federal gift tax, it is a direct skip.

Example 2.

Ted gratuitously conveys Blackacre to Ted's great-grandchild. The transfer is a direct skip. Only one GST tax is imposed on the direct skip although two generations are skipped by the transfer.

With the exception of an outright direct skip, the GST tax return must be filed before the fifteenth day of the fourth month in the year following the taxable year of the transfer. In the case of an outright direct skip transfer, a return must be filed on or before the date for filing the gift or estate tax return.

E. GENERATION SKIPPING TRUST

A common estate-planning tool to avoid the GST is the establishment of a so-called generation-skipping trust. This type of trust can be established either during the lifetime of the trustor or upon his or her death. If it is established while the trustor is still alive, all or part of the GST exemption will be allocated to the trust on the trustor's gift tax return. If the trust is not established until the trustor dies, the executor of the estate will allocate the exemption on the final tax return of the decedent.

Whether the trust is established during the trustor's lifetime or at death, the assets of the trust will also be subject to gift or estate taxes. Therefore, the tax consequences of when the trust is established must be compared. If the trust is established with a lifetime gift, the total transfer tax cost to the trustor is the gift tax and the GST tax. If the transfer takes place at death, the total transfer tax is the estimated estate tax on the decedent's estate (assuming the decedent made no lifetime gifts) plus the GST tax.

Many people also choose to use life insurance to fund a generation-skipping trust. The GST exclusion is applied to the premium rather than the benefit paid upon death. This leaves more of the GST exemption to apply to other assets.

V. State Death Taxes

A. STATES DEATH TAXES: INHERITANCE, ESTATE AND GIFT TAXES

For some people, state taxes are also an issue in estate planning. States levy one of two types of death taxes: inheritance and estate (states also levy gift taxes). Inheritance taxes are imposed on the person receiving the devise, while estate taxes are levied on the estate of the deceased person before assets are distributed to heirs.

Currently a handful of states impose some sort of “death tax” on estates. These are:

- ☐ Indiana;
- ☐ Iowa;
- ☐ Kentucky;
- ☐ Maryland;
- ☐ Nebraska;
- ☐ New Hampshire;
- ☐ New Jersey;
- ☐ Ohio;
- ☐ Oklahoma;
- ☐ Pennsylvania; and
- ☐ Tennessee.

1. Inheritance Tax

Inheritance taxes are normally imposed at graduated rates based upon the amount of the devise and upon the relationship between the deceased and the beneficiary. Several types of exemptions are typically allowed under the inheritance tax:

- ☐ Personal exemptions based on the relationship of the giver and receiver (the most common one is for a surviving spouse);
- ☐ Exemptions of a specified amount allowed the entire estate;
- ☐ Exemptions for property on which a tax already has been paid; and

- ❑ Exemptions for bequests to charitable, religious or educational institutions; and
- ❑ Exemptions for particular types of property.

The personal exemption is usually the most important for state estate tax purposes. There is normally a greater exemption for gifts given to close relatives than to more distant relatives or non-relatives.

Rates also vary significantly between states. In Indiana, for example, lineal descendants are taxed at rates varying from 1 percent on inheritances of up to \$25,000 above the \$100,000 exemption to 10 percent on amounts of \$1.5 million or more above the \$100,000 exemption. In Pennsylvania, they are taxed at a 6 percent rate (for lineal descendants) and non-relatives are taxed at a 15 percent rate, regardless of the amount of inheritance. An individual is not taxed on an inheritance from their spouse.

2. Estate Taxes

Estate taxes are also imposed at graduated rates based upon the value of the estate. Unlike the inheritance tax, the rates generally are imposed on the estate as a whole and do not vary based upon the relationship of the beneficiary to the donor.

Estate tax rates also vary a great deal from state to state. In Ohio, the rates range from 2 percent for taxable estates not exceeding \$40,000 to 7 percent for taxable estates exceeding \$500,000. In New York, estate taxes range from 0 percent for taxable estates up to \$40,000 to 16 percent for taxable estates over \$10 million.

3. Gift Tax

The rates imposed and the exemptions allowed under state gift tax laws are similar to rates and exemptions under the inheritance tax. In the case of a gift tax, however, it is the donor rather than the beneficiary who is liable for payment of the tax.

B. STATE DEATH TAX CREDIT

When the federal estate tax was enacted, so too was a provision that provided a state death tax credit. Individuals have historically been entitled to a credit against the federal tax for death taxes paid to a state. Under the Federal Estate Tax Act of 1926, the maximum credit is 80 percent. This credit is commonly referred to as a "pick-up" tax. The total tax liability for the beneficiaries does not increase and all states currently impose this tax up to the allowable federal credit.

One of the many components of The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phases out the state death tax credit allowed against the federal estate tax in 25% increments between 2002 and 2005. The repeal of the credit was intended to increase revenues to the federal government.

Prior to the enactment of EGTRRA in 2001, 37 states and the District of Columbia used a pick-up tax in which the state death tax was an amount equal to the maximum amount of state death tax credit allowed under federal law.

In five states (New York, North Carolina, Oregon, Virginia and Washington), the state pick-up tax was tied to the federal estate tax as of a particular date prior to the enactment of EGTRRA. In the remaining cases, the state pick-up tax was tied to the federal code on an automatic or rolling basis, meaning that the pick-up tax would phase-out in these states unless the state enacted legislation to the contrary.

The remaining 13 states – Connecticut, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, New Hampshire, New Jersey, Ohio, Oklahoma, Pennsylvania and Tennessee – also coordinated their death taxes (a stand-alone inheritance or estate tax) with the state death tax credit. In these states, the state death tax credit acted as a minimum tax for the stand-alone tax (i.e., the estate was liable for the greater of the death tax credit or the separately computed state tax) or as a supplemental state death tax (i.e., an amount equal to the allowable death tax credit was owed in addition to a state-computed liability).

Of these thirteen states, all except Kansas were tied to the federal code on an automatic or rolling basis prior to the enactment of EGTRRA. In addition, Ohio takes the position that its incorporation of the state death tax credit into its estate tax is not affected by the passage of EGTRRA.

C. POST-EGTRRA STATE ACTION

Since the enactment of EGTRRA, 12 states have taken legislative action to offset all or a part of the impact of the death tax credit phase-out. This includes nine states (D.C., Maine, Massachusetts, Minnesota, Nebraska, North Carolina, Rhode Island, Vermont and Wisconsin) that took legislative action to preserve their pick-up tax. In addition, Maryland, New Jersey and Pennsylvania enacted legislation to tie their use of the death tax credit as a supplemental or minimum tax to the death tax credit as it existed prior to the passage of EGTRRA.

In most cases, the legislative change was accomplished simply by conforming the state law references to the state death tax credit to the federal law at some point prior to the passage of EGTRRA. There were three exceptions:

- ❑ Nebraska enacted a free standing estate tax tied to the federal definitions of the estate tax base, a \$1 million exemption and a rate schedule identical to that of the state death tax credit;
- ❑ Vermont tied its law to the death tax credit as it existed as of 1/1/2001, but adopted the other estate tax provisions of EGTRRA, including the increased exemptions; and
- ❑ North Carolina updated their reference date to conform to the federal estate tax (including increased exemptions) as of May 7, 2001, but provided (for deaths occurring prior to January 1, 2004) that the amount of the state pick-up tax is to be computed without regard to the phase-out of the credit contained in federal law.

Table 14-5. Death Taxes by State and Type

State	Inheritance and pick-up	Estate and pick-up	Pick-up only	Gift
Alabama			X	
Alaska			X	
Arizona			X	
Arkansas			X	
California			X	
Colorado			X	
Connecticut	X			X
Delaware			X	
District of Columbia			X	
Florida			X	
Georgia			X	
Hawaii			X	
Idaho			X	
Illinois			X	
Indiana	X			
Iowa	X			
Kansas			X	
Kentucky	X			
Louisiana	X			X
Maine			X	
Maryland	X			
Massachusetts			X	
Michigan			X	
Minnesota			X	
Mississippi		X		
Missouri			X	
Montana	X			
Nebraska	X			
Nevada			X	
New Hampshire	X			
New Jersey	X			
New Mexico			X	
New York		X		X
North Carolina			X	X
North Dakota			X	
Ohio		X		
Oklahoma		X		
Oregon			X	
Pennsylvania	X			
Rhode Island			X	
South Carolina	X		X	
South Dakota	X			
Tennessee	X			X
Texas			X	

Utah			X	
Vermont			X	
Virginia			X	
Washington			X	
West Virginia			X	
Wisconsin			X	
Wyoming			X	

CHAPTER 14 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following statements about application of the estate and gift tax is correct:
 - a) most gifts are not subject to the gift tax
 - b) most estates are not subject to the estate tax
 - c) most estates are subject to the estate tax
 - d) both a and b above
2. An individual receiving a gift greater than the annual exclusion must file a gift tax return and pay the applicable tax.
 - a) true
 - b) false
3. The estate tax exclusion for the year 2010 is:
 - a) there is no limit
 - b) \$1,000,000
 - c) \$2,000,000
 - d) \$3,500,000
4. Which of the following expenses can be deducted from a decedent's gross estate:
 - a) attorney's fees
 - b) fees for a CPA to prepare the decedent's last tax return
 - c) fees paid to manage the decedent's property
 - d) all of the above
5. Is there a limit on the amount of charitable donations that can be deducted from gross income:
 - a) no, because public policy favors charitable contributions
 - b) yes, charitable donations are only deductible if made at the donor's death
 - c) the amount of the deduction is limited to either 20%, 30%, or 50% of the value of the donor's adjusted gross income, depending on certain circumstances
 - d) yes, a donor is not entitled to deduct charitable donations above 75% of the donor's adjusted gross income, regardless of the circumstances

6. Gifts to an individual's spouse or children are not subject to the federal gift tax.
- a) true
 - b) false
7. Which of the following gifts are exempt from federal gift tax:
- a) payment of tuition by a grandfather directly to the grandchild's college
 - b) payment for surgery made by a best friend directly to the hospital
 - c) gift of a Ferrari from a husband to a wife
 - d) all of the above
8. The federal Generation Skipping Tax never applies to gifts made to non-family members.
- a) true
 - b) false
9. In addition to federal estate taxes, all states impose their own so-called "death tax."
- a) true
 - b) false

CHAPTER 14 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Given the large annual exclusion, most gifts are not subject to gift tax. However, this is not the best answer.

B: Incorrect. Roughly 2% of estates in the United States are subject to the estate tax. However, there is a more accurate answer.

C: Incorrect. The opposite is true.

D: Correct. It is rare for either a gift or an estate to be subject to tax in this country.

(See page 14-2 of the course material.)

2. A: True is incorrect. When required, the obligation to file a gift tax return rests on the donor.

B: False is correct. The person who receives a gift generally will not have to pay any gift tax or file a gift tax return.

(See page 14-3 of the course material.)

3. **A: Correct.** There will be no limit unless Congress acts in 2009 to change it.

B: Incorrect. This was the exclusion in 2003.

C: Incorrect. This was the exclusion in 2006-2008.

D: Incorrect. This is the exclusion for 2009.

(See page 14-4 of the course material.)

4. A: Incorrect. Legal fees associated with an estate are the type of administrative expense that can be deducted from a decedent's gross estate. However, this is not the best answer.

B: Incorrect. This is a deductible administrative expense. However, it is not the correct answer.

C: Incorrect. Fees paid to maintain property during the probate process are deductible administrative expenses. However, this is not the most correct answer.

D: Correct. These are all examples of administrative expenses that can be deducted from the decedent's gross estate.

(See pages 14-5 to 14-6 of the course material.)

5. A: Incorrect. Although this is good policy, federal law limits the amount of deduction that can be taken in a year based upon the adjusted gross income of the donor.

B: Incorrect. Charitable donations are deductible either during the lifetime of the donor or through a trust or will at the time of death that reduces the taxable estate of the donor. Both are subject to limits.

C: Correct. The percentage allowable is based on the type of property and the charity to which the property is donated.

D: Incorrect. The percentage ranges from 20 to 50.

(See page 14-11 of the course material.)

6. A: True is incorrect. Gifts to a child are subject to gift tax.

B: False is correct. Gifts to a spouse are not subject to gift tax; however, there is no exclusion for gifts to a child beyond the normal applicable annual exclusion.

(See pages 14-17 to 14-18 of the course material.)

7. A: Incorrect. There is no cap on the exclusion from gift tax of payments made directly to qualified educational expenses. However, this is not the best answer.

B: Incorrect. This is exempt from gift tax regardless of the relationship of the donor and the beneficiary. However, this is not the best answer.

C: Incorrect. There is an unlimited exclusion for gifts between spouses. However, this is not the best answer.

D: Correct. All of these are examples of gifts not subject to the federal gift tax.

(See pages 14-20 to 14-21 of the course material.)

8. A: True is incorrect. Under some circumstances, gifts to non-family members will trigger application of the Generation Skipping Tax.

B: False is correct. When determining the applicability of the Generation Skipping Tax, non-family members are assigned to the same generation if the individual making the gift and the recipient are within 12½ years of each other in age. A beneficiary with an age difference from the person making the gift of between 12½ and 37½ years is assigned to the second generation. Individuals with an age difference of more than 37½ years are assigned to generations in 25-year increments.

(See page 14-25 of the course material.)

9. A: True is incorrect. Most states do not impose their own death taxes.

B: False is correct. Currently only a handful of states impose their own death taxes on decedent's estates.

(See page 14-29 of the course material.)

Chapter 15: Tax Benefits for Survivors

I. Introduction

Survivors can qualify for certain benefits when filing their *own* income tax returns, including the following:

- ❑ A surviving spouse can file a joint return for the year of death and may qualify for special tax rates for the following two years;
- ❑ If the decedent qualified as a taxpayer's dependent for the part of the year before death, a survivor can claim the exemption for the dependent on their tax return, regardless of when death occurred during the year; or
- ❑ If the decedent was the survivor's qualifying child, the survivor may be able to claim the child tax credit or the earned income credit.

A. QUALIFYING WIDOWS AND WIDOWERS

If a survivor's spouse dies within the two tax years preceding the year for which their return is being filed, the survivor may be eligible to claim the filing status of qualifying widow(er) with dependent child and qualify to use the *Married filing jointly* tax rates.

1. Requirements

Generally, a widow or widower can qualify for this special benefit if they meet all of the following requirements:

- ❑ They were entitled to file a joint return with their spouse for the year of death - whether or not they actually filed jointly;
- ❑ They did not remarry before the end of the current tax year;
- ❑ They have a child, stepchild, or foster child who qualifies as their dependent for the tax year; and
- ❑ They provide more than half the cost of maintaining their home, which is the principal residence of that child for the entire year except for temporary absences.

Example.

William Burns' wife died in 2006. Mr. Burns has not remarried and continued throughout 2007 and 2008 to maintain a home for himself and his dependent child. For 2006 he was entitled to file a joint return for himself and his deceased wife. For 2007 and 2008, he qualifies to file as a qualifying widow(er) with dependent child. For later years, he may qualify to file as a head of household.

The last year an individual can file jointly with, or claim an exemption for their deceased spouse is the year of death. If an individual is the surviving spouse and a personal representative is handling the estate for the decedent, they should coordinate filing their return for the year of death with this personal representative.

B. INCOME IN RESPECT OF THE DECEDENT

All income that the decedent would have received had death not occurred, that was not properly includible on the final return, is income in respect of the decedent. This exclusion does not apply to certain income.

Income in respect of a decedent must be included in the income of one of the following:

- ❑ The decedent's estate, if the estate receives it;
- ❑ The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it; or
- ❑ Any person to whom the estate properly distributes the right to receive it.

If a taxpayer is required to include income in respect of the decedent in their income, they may be able to claim a deduction for the estate tax paid on that income.

Example 1.

Frank Johnson owned and operated an apple orchard. He used the cash method of accounting. He sold and delivered 1,000 bushels of apples to a canning factory for \$2,000, but did not receive payment before his death. The proceeds from the sale are income in respect of the decedent. When the estate was settled, payment had not been made and the estate transferred the right to the payment to his widow. When Frank's widow collects the \$2,000, she must include that amount in her return. It is not reported on the final return of the decedent or on the return of the estate.

Example 2.

Assume the same facts as in Example 1, except that Frank used the accrual method of accounting. The amount accrued from the sale of the apples would be included on his final return. Neither the estate nor the widow would realize income in respect of the decedent when the money is later paid.

Example 3.

On February 1, George High, a cash method taxpayer, sold his tractor for \$3,000, payable March 1 of the same year. His adjusted basis in the tractor was \$2,000. Mr. High died on February 15, before receiving payment. The gain to be reported as income in respect of the decedent is the \$1,000 difference between the decedent's basis in the property and the sale proceeds. In other words, the income in respect of the decedent is the gain the decedent would have realized had he lived.

Example 4.

Cathy O'Neil was entitled to a large salary payment at the date of her death. The amount was to be paid in five annual installments. The estate, after collecting two installments, distributed the right to the remaining installments to Nora, the beneficiary. The payments are income in respect of the decedent. None of the payments were includible on Cathy's final return. The estate must include in its income the two installments it received, and Nora must include in her income each of the three installments as she receives them.

Example 5.

Clair inherited the right to receive renewal commissions on life insurance sold by her father before his death. She inherited the right from her mother, who acquired it by bequest from her father. Clair's mother died before she received all the commissions she had the right to receive, so Clair received the rest. The commissions are income in respect of the decedent. None of these commissions were includible in her father's final return. The commissions received by Clair's mother were included in her income. The commissions Clair received are not includible in her mother's income, even on her final return. Clair must include them in her income.

1. Character of Income

The character of the income received in respect of a decedent is the same as it would be to the decedent if he or she were alive. If the income would have been a capital gain to the decedent, it will be a capital gain to the beneficiary.

2. Transfer of Right to Income

If a beneficiary transfers their right to income in respect of a decedent, they must include in their income the greater of:

- ❑ The amount they received for the right, or
- ❑ The fair market value of the right they transferred.

If a beneficiary makes a gift of such a right, they must include in their income the fair market value of the right at the time of the gift. If the right to income from an installment obligation is transferred, the amount they must include in income is reduced by the basis of the obligation.

A transfer for this purpose includes a sale, exchange, or other disposition, the satisfaction of an installment obligation at other than face value, or the cancellation of an installment obligation.

3. Installment Obligations

If the decedent had sold property using the installment method and a beneficiary collects payments on an installment obligation they acquired from the decedent, they will use the same gross profit percentage the decedent used to figure the part of each payment that represents profit. The beneficiary should include in their income the same profit the decedent would have included had death not occurred.

4. Transfer to Obligor

A transfer of a right to income, discussed earlier, has occurred if the decedent (seller) had sold property using the installment method and the installment obligation is transferred to the obligor (buyer or person legally obligated to pay the installments). A transfer also occurs if the obligation is canceled either at death or by the estate or person receiving the obligation from the decedent. An obligation that becomes unenforceable is treated as having been canceled.

If such a transfer occurs, the amount included in the income of the transferor (the estate or beneficiary) is the greater of the amount received or the fair market value of the installment obligation at the time of transfer, reduced by the basis of the obligation. The basis of the obligation is the decedent's basis, adjusted for all installment payments received after the decedent's death and before the transfer.

If the decedent and obligor were related persons, the fair market value of the obligation cannot be less than its face value.

C. SPECIFIC TYPES OF INCOME IN RESPECT OF A DECEDENT

This section explains and provides examples of some specific types of income in respect of a decedent.

1. Wages

The entire amount of wages or other employee compensation earned by the decedent but unpaid at the time of death is income in respect of the decedent. The income is not reduced by any amounts withheld by the employer. If the income is \$600 or more, the employer should report it in box 3 of Form 1099-MISC and give the recipient a copy of the form or a similar statement.

Wages paid as income in respect of a decedent are not subject to federal income tax withholding. However, if paid during the calendar year of death, they are subject to withholding for social security and Medicare taxes. These taxes should be included on the decedent's Form W-2 with the taxes withheld before death. These wages are not included in box 1 of Form W-2.

Wages paid as income in respect of a decedent after the year of death generally are not subject to withholding for any federal taxes.

2. Farm Income

A farmer's growing crops and livestock at the date of death normally would not give rise to income in respect of a decedent or income to be included in the final return. However, when a cash method farmer receives rent in the form of crop shares or livestock and owns the crop shares or livestock at the time of death, the rent is income in respect of a decedent and is reported in the year in which the crop shares or livestock are sold or otherwise disposed of. The same treatment applies to crop shares or livestock the decedent had a right to receive as rent at the time of death for economic activities that occurred before death.

If the individual died during a rental period, only the proceeds from the portion of the rental period ending with death are income in respect of a decedent. The proceeds from the portion of the rental period from the day after death to the end of the rental period are income to the estate. Cash rent or crop shares and livestock received as rent and reduced to cash by the decedent are includible in the final return even though the rental period did not end until after death.

Example.

Alonzo Roberts, who used the cash method of accounting, leased part of his farm for a 1-year period beginning March 1. The rental was one-third of the crop, payable in cash when the crop share is sold at the direction of Roberts. Roberts died on June 30 and was alive during 122 days of the rental period. Seven months later, Roberts' personal representative ordered the crop to be sold and was paid \$1,500. Of the \$1,500, 122/365, or \$501, is income in respect of a decedent. The balance of the \$1,500 received by the estate, \$999, is income to the estate.

3. Partnership Income

If the partner who died had been receiving payments representing a distributive share or guaranteed payment in liquidation of the partner's interest in a partnership, the remaining payments made to the estate or other successor in interest are income in respect of the decedent. The estate or the successor receiving the payments must include them in income when received. Similarly, the estate or other successor in interest receives income in respect of a decedent if amounts are paid by a third person in exchange for the successor's right to the future payments.

4. U.S. Savings Bonds Acquired from Decedent

If series EE or series I U.S. savings bonds that were owned by a cash method individual who had chosen to report the interest each year (or by an accrual method individual) are transferred because of death, the increase in value of the bonds (interest earned) in the year of death up to the date of death must be reported on the decedent's final return. The transferee (estate or beneficiary) reports on its return only the interest earned after the date of death.

The redemption values of U.S. savings bonds generally are available from local banks, savings and loan institutions, or the Federal Reserve Bank.

If the bonds transferred because of death were owned by a cash method individual who had not chosen to report the interest each year and had purchased the bonds entirely with personal funds, interest earned before death must be reported in one of the following ways:

1. The person (executor, administrator, etc.) who must file the final income tax return of the decedent can *elect* to include in it all of the interest earned on the bonds before the decedent's death. The transferee (estate or beneficiary) then includes in its return only the interest earned after the date of death.
2. If the election in (1), above, was not made, the interest earned to the date of death is income in respect of the decedent and is not included in the decedent's final return. In this case, all of the interest earned before and after the decedent's death is income to the transferee (estate or beneficiary). A transferee who uses the cash method of accounting and who has not chosen to report the interest annually may defer reporting any of it until the bonds are cashed or the date of maturity, whichever is earlier. In the year the interest is reported, the transferee may claim a deduction for any federal estate tax paid that arose because of the part of interest (if any) included in the decedent's estate.

Example 1.

Will's uncle, a cash method taxpayer, died and left him a \$1,000 series EE bond. He had bought the bond for \$500 and had not chosen to report the increase in value each year. At the date of death, interest of \$94 had accrued on the bond, and its value of \$594 at date of death was included in Will's uncle's estate. Will's uncle's personal representative did not choose to include the \$94 accrued interest in the decedent's final income tax return. Will is a cash method taxpayer and does not choose to report the increase in value each year as it is earned. Assuming he cashes it when it reaches maturity value of \$1,000, Will would report \$500 interest income (the difference between maturity value of \$1,000 and the original cost of \$500) in that year. Will is also entitled to claim, in that year, a deduction for any federal estate tax resulting from the inclusion in his uncle's estate of the \$94 increase in value.

Example 2.

If, in Example 1, the personal representative had chosen to include the \$94 interest earned on the bond before death in the final income tax return of Will's uncle, he would report \$406 (\$500 - \$94) as interest when he cashed the bond at maturity. This \$406 represents the interest earned after his uncle's death and was not included in his estate, so no deduction for federal estate tax is allowable for this amount.

Example 3.

Will's uncle died owning series HH bonds that he acquired in exchange for series EE bonds. Will was the beneficiary on these bonds. His uncle used the cash method of accounting and had not chosen to report the increase in redemption price of the series EE bonds each year as it accrued. His uncle's personal representative made no election to include any interest earned before death in the decedent's final return. Will's income in respect of the decedent is the sum of the unreported increase in value of the series EE bonds, which constituted part of the amount paid for series HH bonds, and the interest, if any, payable on the series HH bonds but not received as of the date of the decedent's death.

5. Interest Accrued on U.S. Treasury Bonds

The interest accrued on U.S. Treasury bonds owned by a cash method taxpayer and redeemable for the payment of federal estate taxes that was not received as of the date of the individual's death is income in respect of the decedent. This interest is not included in the decedent's final income tax return. The estate will treat such interest as taxable income in the tax year received if it chooses to redeem the U.S. Treasury bonds to pay federal estate taxes.

If the person entitled to the bonds (by bequest, devise, or inheritance, or because of the death of the individual) receives them, that person will treat the accrued interest as taxable income in the year the interest is received. Interest that accrues on the U.S. Treasury bonds after the owner's death does not represent income in respect of the decedent. The interest, however, is taxable income and must be included in the income of the respective recipients.

6. Interest Accrued on Savings Certificates

The interest accrued on savings certificates (redeemable after death without forfeiture of interest) that is for the period from the date of the last interest payment and ending with the date of the decedent's death, but not received as of that date, is income in respect of a decedent. Interest for a period after the decedent's death that becomes payable on the certificates after death is not income in respect of a decedent, but is taxable income includible in the income of the respective recipients.

7. Inherited IRAs

If a beneficiary receives a lump-sum distribution from a traditional IRA he or she inherited, all or some of it may be taxable. The distribution is taxable in the year received as income in respect of a decedent up to the decedent's taxable balance. This is the decedent's balance at the time of death, including unrealized appreciation and income accrued to date of death, minus any basis (nondeductible contributions). Amounts distributed that are more than the decedent's entire IRA balance (includes taxable and nontaxable amounts) at the time of death are the income of the beneficiary.

If the beneficiary of a traditional IRA is the decedent's surviving spouse who properly rolls over the distribution into another traditional IRA, the distribution is not currently taxed. A surviving spouse also can roll over tax free the taxable part of the distribution into a qualified plan, section 403 annuity, or section 457 plan.

Example 1.

At the time of his death, Greg owned a traditional IRA. All of the contributions by Greg to the IRA had been deductible contributions. Greg's nephew, Mark, was the sole beneficiary of the IRA. The entire balance of the IRA, including income accruing before and after Greg's death, was distributed to Mark in a lump sum. Mark must include the total amount received in his income. The portion of the lump-sum distribution that equals the amount of the balance in the IRA at Greg's death, including the income earned before death, is income in respect of the decedent. Mark may take a deduction for any federal estate taxes that were paid on that portion.

Example 2.

Assume the same facts as in Example 1, except that some of Greg's contributions to the IRA had been nondeductible contributions. To determine the amount to include in income, Mark must subtract the total nondeductible contributions made by Greg from the total amount received (including the income that was earned in the IRA both before and after Greg's death). Income in respect of the decedent is the total amount included in income less the income earned after Greg's death.

8. Roth IRAs

Qualified distributions from a Roth IRA are not subject to tax. A distribution made to a beneficiary or to the Roth IRA owner's estate on or after the date of death is a qualified distribution if it is made after the 5-tax-year period beginning with the first tax year in which a contribution was made to any Roth IRA of the owner.

Generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over his or her life or life expectancy. If paid as an annuity, the distributions must begin before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, the spouse can delay the distributions until the decedent would have reached age 70½ or can treat the Roth IRA as his or her own Roth IRA.

Part of any distribution to a beneficiary that is not a qualified distribution may be includible in the beneficiary's income. Generally, the part includible is the earnings in the Roth IRA. Earnings attributable to the period ending with the decedent's date of death are income in respect of the decedent. Additional earnings are the income of the beneficiary.

9. Coverdell Education Savings Account (ESA)

Generally, the balance in a Coverdell ESA must be distributed within 30 days after the individual for whom the account was established reaches age 30 or dies, whichever is earlier. The treatment of the Coverdell ESA at the death of an individual under age 30 depends on who acquires the interest in the account.

The age 30 limitation does not apply if the individual for whom the account was established or the beneficiary that acquires the account is an individual with special needs. This includes an individual who, because of a physical, mental, or emotional condition (including learning disability), requires additional time to complete his or her education. If the decedent's spouse or other family member is the designated beneficiary of the decedent's account, the Coverdell ESA becomes that person's Coverdell ESA.

Any other beneficiary (including a spouse or family member who is not the designated beneficiary) must include in income the earnings portion of the distribution. Any balance remaining at the close of the 30-day period is deemed to be distributed at that time. The amount included in income is reduced by any qualified education expenses of the decedent that are paid by the beneficiary within 1 year after the decedent's date of death. An estate tax deduction, discussed later, applies to the amount included in income by a beneficiary other than the decedent's spouse or family member.

10. Archer MSA

The treatment of an Archer MSA or a Medicare Advantage MSA, at the death of the account holder depends on who acquires the interest in the account. If the decedent's spouse is the designated beneficiary of the account, the account becomes that spouse's Archer MSA.

Any other beneficiary (including a spouse that is not the designated beneficiary) must include in income the fair market value of the assets in the account on the decedent's date of death. This amount must be reported for the beneficiary's tax year that includes the decedent's date of death. The amount included in income is reduced by any qualified medical expenses for the decedent that are paid by the beneficiary within one year after the decedent's date of death. An estate tax deduction, discussed later, applies to the amount included in income by a beneficiary other than the decedent's spouse.

D. DEDUCTIONS IN RESPECT OF THE DECEDENT

Items such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable but that are not properly allowable as deductions on the decedent's final income tax return will be allowed as a deduction to one of the following when paid:

- ☐ The estate; or
- ☐ The person who acquired an interest in the decedent's property (subject to such obligations) because of the decedent's death, if the estate was not liable for the obligation.

Similar treatment is given to the foreign tax credit. A beneficiary who must pay a foreign tax on income in respect of a decedent will be entitled to claim the foreign tax credit.

1. Depletion

The deduction for percentage depletion is allowable only to the person (estate or beneficiary) who receives income in respect of the decedent to which the deduction relates, whether or not that person receives the property from which the income is derived. An heir who (because of the decedent's death) receives income as a result of the sale of units of mineral by the decedent (who used the cash method) will be entitled to the depletion allowance for that income. If the decedent had not figured the deduction on the basis of percentage depletion, any depletion deduction to which the decedent was entitled at the time of death would be allowable on the decedent's final return, and no depletion deduction in respect of the decedent would be allowed to anyone else.

2. Estate Tax Deduction

Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the recipient (estate or beneficiary). However, an income tax deduction is allowed to the recipient for the estate tax paid on the income.

The deduction for estate tax can be claimed only for the same tax year in which the income in respect of the decedent must be included in the recipient's income. (This also is true for income in respect of a prior decedent.)

Individuals can claim this deduction only as an itemized deduction, on line 27 of Schedule A (Form 1040). This deduction is *not* subject to the 2% limit on miscellaneous itemized deductions. Estates can claim the deduction on the line provided for the deduction on Form 1041. For the alternative minimum tax computation, the deduction is not included in the itemized deductions that are an adjustment to taxable income.

If the income in respect of the decedent is capital gain income, you must reduce the gain, but not below zero, by any deduction for estate tax paid on such gain. This applies in figuring the following:

- ☐ The maximum tax on net capital gain.
- ☐ The 50% exclusion for gain on small business stock.
- ☐ The limitation on capital losses.

3. Computation

To figure a recipient's estate tax deduction, determine –

- ☐ The estate tax that qualifies for the deduction, and
- ☐ The recipient's part of the deductible tax.

4. Deductible Estate Tax

The estate tax is the tax on the taxable estate, reduced by any credits allowed. The estate tax qualifying for the deduction is the part of the net value of all the items in the estate that represents income in respect of the decedent. *Net value* is the excess of the items of income in respect of the decedent over the items of expenses in respect of the decedent. The deductible estate tax is the difference between the actual estate tax and the estate tax determined without including net value.

Example.

Jack used the cash method of accounting. At the time of his death, he was entitled to receive \$12,000 from clients for his services and he had accrued bond interest of \$8,000, for a total income in respect of the decedent of \$20,000. He also owed \$5,000 for business expenses for which his estate is liable. The income and expenses are reported on Jack's estate tax return.

The tax on Jack's estate is \$9,460 after credits. The net value of the items included as income in respect of the decedent is \$15,000 (\$20,000 - \$5,000). The estate tax determined without including the \$15,000 in the taxable estate is \$4,840, after credits. The estate tax that qualifies for the deduction is \$4,620 (\$9,460 - \$4,840).

Figure the recipient's part of the deductible estate tax by dividing the estate tax value of the items of income in respect of the decedent included in the recipient's income (the numerator) by the total value of all items included in the estate that represents income in respect of the decedent (the denominator). If the amount included in the recipient's income is less than the estate tax value of the item, use the lesser amount in the numerator.

The estate tax deduction allowed an estate is figured in the same manner as just discussed. However, any income in respect of a decedent received by the estate during the tax year is reduced by any such income that is properly paid, credited, or required to be distributed by the estate to a beneficiary. The beneficiary would include such distributed income in respect of a decedent for figuring the beneficiary's deduction.

For the estate tax deduction, an annuity received by a surviving annuitant under a joint and survivor annuity contract is considered income in respect of a decedent. The deceased annuitant must have died after the annuity starting date. A special computation must be made to figure the estate tax deduction for the surviving annuitant.

CHAPTER 15 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. At the death of their spouse, a surviving spouse can no longer file a joint return, unless they remarry.
 - a) true
 - b) false
2. The character of the income received in respect of a decedent is the same as it would have been to the decedent if he or she were alive.
 - a) true
 - b) false
3. The entire amount of wages or other employee compensation earned by the decedent but unpaid at the time of death is income in respect of the decedent.
 - a) true
 - b) false
4. There are no allowable deductions in respect of the decedent.
 - a) true
 - b) false

CHAPTER 15 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. A surviving spouse can file a joint return for the year of death and may qualify for special tax rates for the following two years.

B: False is correct. If the surviving spouse meets specific requirements, they may file a joint return for the year of death and qualify for special tax rates for the following two years.

(See page 15-1 of the course material.)

2. **A: True is correct.** If the income would have been a capital gain to the decedent, it will be a capital gain to the beneficiary.

B: False is incorrect. Income received in respect of the decedent maintains the same character as it would have had if the decedent were still alive.

(See page 15-3 of the course material.)

3. **A: True is correct.** The income is not reduced by any amounts withheld by the employer.

B: False is incorrect. Wages paid as income in respect of a decedent are not subject to federal income tax withholding, but if paid during the calendar year of death, they are subject to withholding for social security and Medicare taxes.

(See page 15-4 of the course material.)

4. A: True is incorrect. Items such as business expenses, income-producing expenses, interest and taxes, for which the decedent was liable but that are not properly allowable as deductions on the decedent's final income tax return will be allowed as a deduction when paid.

B: False is correct. Deductions may be allowed to either the estate or the person who acquired an interest in the decedent's property because of the decedent's death, if the estate was not liable for the obligation when the expenses were paid.

(See page 15-9 of the course material.)

Chapter 16: Life Insurance and Variable Annuities

I. Life Insurance

Life insurance can be a good estate planning tool for a number of reasons, most notably:

- ❑ The insured usually pays little up front for the policy;
- ❑ The proceeds of the policy pass directly to the beneficiaries without going through probate; and
- ❑ The benefits are not generally subject to federal income tax.

However, today's complex financial markets give individuals a host of other options when considering life insurance, including policies that can add to retirement income. This section will outline the major types of life insurance available and provide some pointers for determining what type of insurance is best in a certain situation, particularly considering its tax implications.

A. THE NATURE OF LIFE INSURANCE

A life insurance policy is a contract. In the contract, the insurer promises to pay proceeds of the policy to the beneficiaries in the event the insured dies. The owner of the policy has the right to name the beneficiary and change the beneficiary as often as he or she likes unless the designation is made irrevocable.

The primary beneficiary is entitled to the proceeds only if he or she survives the insured. Contingent beneficiaries must likewise survive the insured. Thus, in cases of a class that has both surviving and deceased members, only those surviving will receive payment. Settlement options include both installment payments or payment at a future date. The owner of the policy can select the settlement option.

B. WHO NEEDS LIFE INSURANCE?

Almost anyone with dependents should have some type of life insurance policy (the exception may be someone who is so wealthy that it is totally unnecessary to provide the additional assets to survivors upon death). But for most, the only questions are the amount of insurance they should have and the type.

In analyzing the amount of life insurance someone should have, the following list of questions is a good place to start:

- ❑ Are you married?
- ❑ Do you still have children living at home, or, if not living at home, are they still dependent (i.e. college tuition)?
- ❑ Do you own a small business that would likely suffer if you were to suddenly die?

- ❑ Is there anyone else you support, such as an elderly parent?
- ❑ What type of financial obligations do you have, i.e. a large mortgage on your home or a loan to support your business?

The answers to these and other questions can help determine the amount of insurance that is right for a particular individual. Clearly, for example, someone who has a spouse and several small children living at home with a large mortgage is going to need more life insurance than a single person whose children are grown and whose house is paid for.

Making the precise determination about how much insurance is needed also depends on other assets that are likely to be available at the time of death. Will a surviving spouse be entitled to the deceased's retirement benefits? Will they be entitled to continuing employer-sponsored health benefits? A thorough examination of an individual's current and future expected finances is necessary to determine an appropriate amount of life insurance.

As a rule of thumb, however, some financial experts recommend that individuals have a life insurance policy sufficient to replace two to six times their annual income, depending on individual needs. Therefore, if an individual has an annual income of \$100,000, their life insurance policy should be for between \$200,000 and \$600,000.

C. SELECTING A BENEFICIARY

If an individual is married and has dependent children, their spouse is most likely going to be the beneficiary of their life insurance policy. If the individual is unmarried and has small children, they will likely need to select a trustee to manage the proceeds of the insurance policy. In such a case, the children would technically be the beneficiaries, but the proceeds would be placed in a trust managed by a third party. Each person's circumstances are different. Generally, the life insurance should be paid to the person or persons for whom the deceased was responsible during their lifetime.

D. OVERVIEW OF TYPES OF LIFE INSURANCE

Traditionally, there were basically two types of life insurance: term, or "pure" life insurance, or whole life, also referred to as investment insurance. Term insurance provides protection for a specified term of years. It is normally cheaper than whole insurance, particularly when the insured is relatively young. It has value only if the insured dies. Whole insurance, on the other hand, has some cash value even if the insured does not die. It is normally more expensive than simple term insurance. Its utility as an estate planning or an investment tool is normally fairly limited. In today's marketplace, individuals also have to consider three other options: variable life insurance, universal life insurance and universal variable life insurance.

Table 16-1. Type of Life Insurance

Type of Policy	Positives	Negatives
Term Life	<ul style="list-style-type: none"> • Usually inexpensive. 	<ul style="list-style-type: none"> • No cash value; • Not always renewable.
Whole Life	<ul style="list-style-type: none"> • Pays a death benefit to the beneficiary and a low risk cash value account and tax-deferred cash accumulation; • Provides a fixed premium which cannot increase during insured's lifetime as long as payments are made; • Insurance company manages the cash value of policy; • Insured can receive dividends or use them to defray premiums; • Funds can be withdrawn during insured's lifetime. 	<ul style="list-style-type: none"> • Does not allow insured opportunity to select own investment options; • Does not allow insured to move money between accounts; • Does not offer flexibility in amount of premium or face amount of policy.
Variable Life	<ul style="list-style-type: none"> • Pays a death benefit to the beneficiary and provides insured with low-risk, tax-free cash accumulation; • Allows the death benefit to vary in relation to the fund returns of the cash value account; • Allows insured to borrow from the policy during their lifetime. 	<ul style="list-style-type: none"> • Offers no guarantee to the amount of cash value during insured's lifetime; • Provides no premium or face amount flexibility.
Universal Life	<ul style="list-style-type: none"> • Pays a death benefit to named beneficiary and offers low-risk cash value account and tax-deferred accumulation; • Allows insured to earn market rates of interest on cash value account; • Offers the right to borrow or withdraw from the policy during insured's lifetime; Allows premium and face amount flexibility. 	<ul style="list-style-type: none"> • Does not allow insured to invest in separate accounts such as money market or stock funds; • Does not allow flexibility to split money between different accounts.

Universal Variable Life	<ul style="list-style-type: none"> • Pays a death benefit to the beneficiary and offers low-risk tax-deferred cash value options; • Offers separate accounts for investment, such as stock and bond funds; • Offers premium flexibility; • Allows insured to make withdrawals or to borrow from the policy during their lifetime. 	<ul style="list-style-type: none"> • Requires policyholder to devote time to manage the accounts; • Does not work well with small premium amounts because premium must cover insurance and accounts.
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1. Term Life Insurance

Term life insurance is “pure” life insurance. It has a value only if the insured dies during the life of the policy. If the insured outlives the stated term of the policy, it has absolutely no value. Most term life insurance policies have specific terms. When purchasing a term life insurance policy, one should always determine if and under what circumstances the policy is renewable. That is because such a policy might be relatively inexpensive for an individual who is healthy and 30 years old. But what happens if, when the policy expires, the individual has become quite ill. Will they have the option of renewing? And at what price? Term life insurance is cheapest to buy when an individual is young. Rates generally increase with age.

2. Whole Life Insurance

Whole life insurance offers the combination of “pure” life insurance along with an investment component. The cost of the premiums covers the pure insurance as well as amounts invested by the insurance company. As a result, it is more expensive than term life insurance. Whole life policies often guarantee a minimum rate of return, often between four and six percent. If the investment selections are good, the cash value of the account can exceed the guaranteed return.

a. Income Tax Liability

There is no income tax liability on the account unless the policy is canceled and the proceeds withdrawn. Many such policies will also allow the insured to borrow against their account. The interest on these loans is generally credited to the insured's account. By "borrowing" the cash from your whole life insurance policy, no taxable event is triggered.

b. Cash Value

Technically, the cash values are supposed to be explained as tax deferred, not tax-free. The truth is, they may only be tax deferred, meaning tax will have to be paid on them someday; or they may end up being tax-free altogether. If the individual dies, the actual life insurance portion and the cash value are lumped together as one whole and called

the death benefit, or life insurance proceeds, which, under most circumstances, are exempt from income tax.

3. Variable Life Insurance

Variable life insurance is similar to whole life insurance, except the cash value and/or the death benefits are not fixed. They vary depending on the results of the investments made from the owner's separate account. The owner of the policy chooses how the money is invested.

The insurance company will offer a list of different types of investment accounts to choose from such as stock funds, bond funds, or money market funds. The individual investment accounts are managed by either the insurance company itself, or by an outside investment firm. The goal of variable life insurance is for the death benefits to keep up with the rate of inflation.

4. Universal Life Insurance

Universal life insurance is permanent life insurance that includes both pure insurance and investment components, similar to whole life. However, universal life insurance allows the owner to adjust either the amount of premiums to be paid or the amount of the death benefits to be paid at death. The rate of return on the investment component is based on the results of the company's general asset account. The owner is not allowed to dictate what type of investments are made.

Because universal life insurance is intended to be a policy that individuals maintain during their entire life, the premiums can be adjusted so that they are equal over their lifetime, they pay them only for a set number of years, or they are more in the beginning years and then lower in later years, for example after the individual retires.

5. Universal Variable Life Insurance

Universal variable life insurance combines the features of universal insurance and variable insurance. The owner is able to choose the types of investments made by the cash value account and the account grows according to the returns on those investments. The owner can also adjust the amount of the premiums or death benefit of the policy. This type of policy offers the owner the most flexibility in meeting his/her insurance needs.

E. IMPACT OF INSURANCE ON TAXABLE INCOME

The proceeds from a decedent's life insurance policy paid by reason of his or her death generally are excluded from income. The exclusion applies to any beneficiary, whether a family member or other individual, a corporation, or a partnership.

1. Veterans' Insurance Proceeds

Veterans' insurance proceeds and dividends are not taxable either to the veteran or to the beneficiaries. Interest on dividends left on deposit with the Department of Veterans Affairs is not taxable.

2. Life Insurance Proceeds

Life insurance proceeds paid because of the death of the insured (or because the insured is a member of the U.S. uniformed services who is missing in action) are not taxable unless the policy was turned over for a price. This is true even if the proceeds are paid under an accident or health insurance policy or an endowment contract.

3. Accelerated Death Benefits

Accelerated death benefits received on the life of an insured individual can be excluded from income if certain requirements are met. Accelerated death benefits are amounts received under a life insurance contract before the death of the insured. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider. This exclusion applies only if the insured was a terminally ill individual or a chronically ill individual. This exclusion does not apply if the insured is a director, officer, employee, or has a financial interest, in any trade or business carried on by the beneficiary.

a. Terminally Ill Individual

A terminally ill individual is one who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death in 24 months or less from the date of certification.

b. Chronically Ill Individual

A chronically ill individual is one who has been certified as one of the following:

- ❑ An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to a loss of functional capacity; and
- ❑ An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

A certification must have been made by a licensed health care practitioner within the previous 12 months.

c. Exclusion Limited

If the insured was a chronically ill individual, the exclusion of accelerated death benefits is limited to the cost incurred in providing qualified long-term care services for the insured. In determining the cost incurred, do not include amounts paid or reimbursed by insurance or otherwise. Subject to certain limits, payments received on a periodic basis can be excluded without regard to their costs.

4. Insurance Received in Installments

If an individual receives life insurance proceeds in installments, they can exclude part of each installment from their income.

To determine the part excluded, an individual must divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. They include anything over this excluded part in their income as interest.

a. Specified Number of Installments

If an individual will receive a specified number of installments under the insurance contract, they can figure the part of each installment they can exclude by dividing the amount held by the insurance company by the number of installments to which they are entitled. A secondary beneficiary, in case the individual dies before receiving all of the installments, is entitled to the same exclusion.

Example.

As beneficiary, Mary chooses to receive \$40,000 of life insurance proceeds in ten annual installments of \$6,000. Each year, Mary can exclude from her income \$4,000 ($\$40,000 \div 10$) as a return of principal. The balance of the installment, \$2,000, is taxable as interest income.

b. Specified Amount Payable

If each installment an individual receives under the insurance contract is a specific amount based on a guaranteed rate of interest, but the number of installments the individual will receive is uncertain, the part of each installment that they can exclude from income is the amount held by the insurance company divided by the number of installments necessary to use up the principal and guaranteed interest in the contract.

Example.

The face amount of the policy is \$200,000, and as beneficiary John chooses to receive annual installments of \$12,000. The insurer's settlement option guarantees John this amount for 20 years based on a guaranteed rate of interest. It also provides that extra interest may be credited to the principal balance according to the insurer's earnings. The excludable part of each guaranteed installment is \$10,000 ($\$200,000 \div 20$ years). The balance of each guaranteed installment, \$2,000, is interest income to John. The full amount of any additional payment for interest is income to John.

c. Installments for Life

If, as the beneficiary under an insurance contract, an individual is entitled to receive the proceeds in installments for the rest of their life without a refund or period-certain guarantee, they must figure the excluded part of each installment by dividing the amount held by the insurance company by their life expectancy. If there is a refund or period-certain guarantee, the amount held by the insurance company for this purpose is reduced by the actuarial value of the guarantee.

Example.

As beneficiary, Roger chooses to receive the \$50,000 proceeds from a life insurance contract under a life-income-with-cash-refund option. Roger is guaranteed \$2,700 a year for the rest of his life (which is estimated by use of mortality tables to be 25 years from the insured's death). The actuarial value of the refund feature is \$9,000. The amount held by the insurance company, reduced by the value of the guarantee, is \$41,000 (\$50,000 - \$9,000) and the excludable part of each installment representing a return of principal is \$1,640 ($\$41,000 \div 25$). The remaining \$1,060 ($\$2,700 - \$1,640$) is interest income to Roger. If Roger should die before receiving the entire \$50,000, the refund payable to the refund beneficiary is not taxable.

5. Interest Option on Insurance

If an insurance company pays an individual interest only on proceeds from life insurance left on deposit, the interest the individual is paid is taxable.

6. Flexible Premium Contracts

A life insurance contract (including any qualified additional benefits) is a flexible premium life insurance contract if it provides for the payment of one or more premiums that are not fixed by the insurer as to both timing and amount. For a flexible premium contract issued before January 1, 1985, the proceeds paid under the contract because of the death of the insured will be excluded from the recipient's income only if the contract meets the requirements explained under section 101(f) of the Internal Revenue Code.

II. Variable Annuities**A. OVERVIEW**

Variable annuities have become a part of the retirement and investment plans of many Americans. This section will provide a general description of variable annuities – what they are, how they work, and the charges investors often pay.

A variable annuity is a contract between an individual and an insurance company, under which the insurer agrees to make periodic payments to the investor, beginning either immediately or at some future date. An individual purchases a variable annuity contract by making either a single purchase payment or a series of purchase payments.

A variable annuity offers a range of investment options. The value of the investment will vary depending on the performance of the investment options chosen. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three.

Although variable annuities are typically invested in mutual funds, variable annuities differ from mutual funds in several important ways:

- ❑ First, variable annuities let investors receive periodic payments for the rest of their life (or the life of his or her spouse or any other person so designated). This feature offers protection against the possibility that, after the investor retires, they will outlive their assets;
- ❑ Second, variable annuities have a death benefit. If the owner dies before the insurer has started making payments, the beneficiary is guaranteed to receive a specified amount – typically at least the amount of the investor's purchase payments. The beneficiary will get a benefit from this feature if, at the time of the investor's death, the account value is less than the guaranteed amount; and
- ❑ Third, variable annuities are tax-deferred. That means the investor pays no taxes on the income and investment gains from the annuity until he or she withdraws their money. Investors may also transfer their money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When money is taken out of a variable annuity, however, the investor will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if the investor holds it as a long-term investment to meet retirement and other long-range goals.

B. TAX CONSIDERATIONS

Accountants should remember that other retirement vehicles, such as IRAs and employer-sponsored 401(k) plans, also may provide investors with tax-deferred growth and other tax advantages. For most investors, it will be advantageous to make the maximum allowable contributions to IRAs and 401(k) plans before investing in a variable annuity. In addition, if an individual is investing in a variable annuity through a tax-advantaged retirement plan (such as a 401(k) plan or IRA), they will get no additional tax advantage from the variable annuity. Under these circumstances, the individual should consider buying a variable annuity only if it makes sense because of the annuity's other features, such as lifetime income payments and death benefit protection.

C. LONG-TERM INVESTMENT OPTION

Variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are usually not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if investors withdraw their money early. Variable annuities also involve investment risks, just as mutual funds do.

D. INVESTMENT PHASES

A variable annuity has two phases: an accumulation phase and a pay-out phase.

1. Accumulation Phase

During the accumulation phase, investors make purchase payments, which can be allocated to a number of investment options.

Example 1.

John could designate 40% of his purchase payments to a bond fund, 40% to a U.S. stock fund, and 20% to an international stock fund. The money John has allocated to each mutual fund investment option will increase or decrease over time, depending on the fund's performance.

Variable annuities often allow investors to allocate part of their purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum (e.g., 3% per year).

Example 2.

Jillian purchased a variable annuity with an initial purchase payment of \$10,000. She allocated 50% of that purchase payment (\$5,000) to a bond fund, and 50% (\$5,000) to a stock fund. Over the following year, the stock fund has a 10% return, and the bond fund has a 5% return. At the end of the year, Jillian's account has a value of \$10,750 (\$5,500 in the stock fund and \$5,250 in the bond fund), minus fees and charges.

An investor's most important source of information about a variable annuity's investment options is the prospectus. Investors considering a variable annuity should request the prospectuses for the mutual fund investment options and read them carefully before allocating purchase payments among the investment options offered. Factors to be considered in making an allocation include the following:

- ❑ The fund's investment objectives and policies;
- ❑ Management fees and other expenses that the fund charges;
- ❑ The risks and volatility of the fund; and
- ❑ Whether the fund contributes to the diversification of the investor's overall investment portfolio.

During the accumulation phase, investors can typically transfer their money from one investment option to another without paying tax on investment income and gains, although the investor may be charged by the insurance company for transfers.

However, if the investor withdraws money from their account during the early years of the accumulation phase, he or she may have to pay "surrender charges," which are discussed below. In addition, he or she may have to pay a 10% federal tax penalty if the money is withdrawn before the age of 59½.

2. Pay-Out Phase

At the beginning of the pay-out phase, investors may receive their purchase payments plus investment income and gains (if any) as a lump-sum payment, or may choose to receive them as a stream of payments at regular intervals (generally monthly).

If an investor chooses to receive a stream of payments, they may have a number of choices of how long the payments will last. Under most annuity contracts, investors can choose to have their annuity payments last for a period determined by him or her (such as 20 years) or for an indefinite period (such as their lifetime or the lifetime of him or her and his or her spouse or other beneficiary). During the pay-out phase, an investor's annuity contract may permit him to choose between receiving payments that are fixed in amount or payments that vary based on the performance of mutual fund investment options.

The amount of each periodic payment will depend, in part, on the time period that the investor selects for receiving payments. Remember, however, that some annuities do not allow investors to withdraw money from their account once they have started to receive regular annuity payments.

In addition, some annuity contracts are structured as immediate annuities, which means that there is no accumulation phase and investors will start receiving annuity payments right after they purchase the annuity.

E. THE DEATH BENEFIT AND OTHER FEATURES

A common feature of variable annuities is the death benefit. If the investor dies, a person he or she selects as a beneficiary (such as their spouse or child) will receive the greater of: (i) all the money in the account, or (ii) some guaranteed minimum (such as all purchase payments minus prior withdrawals).

Example.

Martin owns a variable annuity that offers a death benefit equal to the greater of account value or total purchase payments minus withdrawals. He has made purchase payments totaling \$50,000. In addition, he has withdrawn \$5,000 from his account. Because of these withdrawals and investment losses, his account value is currently \$40,000. If he dies, his designated beneficiary will receive \$45,000 (the \$50,000 in purchase payments he put in minus \$5,000 in withdrawals).

Some variable annuities allow investors to choose a "stepped-up" death benefit. Under this feature, the guaranteed minimum death benefit may be based on a greater amount than purchase payments minus withdrawals. For example, the guaranteed minimum might be the account value as of a specified date, which may be greater than purchase payments minus withdrawals if the underlying investment options have performed well. The purpose of a stepped-up death benefit is to "lock in" the investment performance and prevent a later decline in the value of the account from eroding the amount that the investor expects to leave to their heirs. This feature carries a charge, however, which will reduce the value of the account.

Variable annuities sometimes offer other optional features, which also have extra charges. One common feature, the guaranteed minimum income benefit, guarantees a particular minimum level of annuity payments, even if the investor does not have enough money in their account (perhaps because of investment losses) to support that level of payments. Other features may include long-term care insurance, which pays for home health care or nursing home care if the investor becomes seriously ill.

F. VARIABLE ANNUITY CHARGES

Investors will pay several charges when they invest in a variable annuity. These charges will reduce the value of their account and the return on the investment. Often, they will include the following.

1. Surrender Charges

If the investor withdraws money from a variable annuity within a certain period after a purchase payment (typically within six to eight years, but sometimes as long as ten years), the insurance company usually will assess a "surrender" charge, which is a type of sales charge. This charge is used to pay the investor's financial professional a commission for selling the variable annuity. Generally, the surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the "surrender period."

For example, a 7% charge might apply in the first year after a purchase payment, 6% in the second year, 5% in the third year, and so on until the eighth year, when the surrender charge no longer applies. Often, contracts will allow investors to withdraw part of their account value each year – 10% or 15% of their account value, for example – without paying a surrender charge.

Example.

Lisa purchases a variable annuity contract with a \$10,000 purchase payment. The contract has a schedule of surrender charges, beginning with a 7% charge in the first year, and declining by 1% each year. In addition, Lisa is allowed to withdraw 10% of her contract value each year free of surrender charges.

In the first year, Lisa decides to withdraw \$5,000, or one-half of her contract value of \$10,000 (assuming that her contract value has not increased or decreased because of investment performance). In this case, Lisa could withdraw \$1,000 (10% of contract value) free of surrender charges; she would pay a surrender charge of 7%, or \$280, on the other \$4,000 withdrawn.

2. Mortality and Expense Risk Charge

This charge is equal to a certain percentage of the account's value, typically in the range of 1.25% per year. This charge compensates the insurance company for insurance risks it assumes under the annuity contract. Profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the variable annuity, such as a commission paid to the investor's financial professional for selling the variable annuity to him.

Example.

Tyler's variable annuity has a mortality and expense risk charge of an annual rate of 1.25% of account value. His average account value during the year is \$20,000, so he will pay \$250 in mortality and expense risk charges that year.

3. Administrative Fees

The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps \$25 or \$30 per year) or as a percentage of the account value (typically in the range of 0.15% per year).

Example.

Paul's variable annuity charges administrative fees at an annual rate of 0.15% of account value. His average account value during the year is \$50,000. He will pay \$75 in administrative fees.

4. Underlying Fund Expenses

Investors will also indirectly pay the fees and expenses imposed by the mutual funds that are the underlying investment options for their variable annuity.

5. Fees and Charges for Other Features

Special features offered by some variable annuities, such as a stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and charges. Other charges, such as initial sales loads, or fees for transferring part of an investor's account from one investment option to another, may also apply.

G. TAX FREE "1035" EXCHANGES

Section 1035 of the U.S. tax code allows investors to exchange an existing variable annuity contract for a new annuity contract without paying any tax on the income and investment gains in their current variable annuity account. These tax-free exchanges, known as 1035 exchanges, can be useful if another annuity has preferred features, such as a larger death benefit, different annuity pay-out options, or a wider selection of investment choices.

Investors may, however, be required to pay surrender charges on the old annuity if they are still in the surrender charge period. In addition, a new surrender charge period generally begins when he exchanges into the new annuity. This means that, for a significant number of years (as many as 10 years), an investor typically will have to pay a surrender charge (which can be as high as 9% of his or her purchase payments) if they withdraw funds from the new annuity. Further, the new annuity may have higher annual fees and charges than the old annuity, which will reduce the investment's returns. If an investor surrenders an old annuity for cash and *then* buys a new annuity, they will have to pay tax on the surrender.

H. BONUS CREDITS

Some insurance companies are now offering variable annuity contracts with "bonus credit" features. These contracts promise to add a bonus to an investor's contract value based on a specified percentage (typically ranging from 1% to 5%) of purchase payments.

Example.

Stasia purchases a variable annuity contract that offers a bonus credit of 3% on each purchase payment. She makes a purchase payment of \$20,000. The insurance company issuing the contract adds a bonus of \$600 to her account.

Remember, however, that variable annuities with bonus credits may carry a downside, however – higher expenses that can outweigh the benefit of the bonus credit offered.

Frequently, insurers will also charge investors for bonus credits in one or more of the following ways:

- ❑ Charges may be higher for a variable annuity that pays investors a bonus credit than for a similar contract with no bonus credit;
- ❑ An investor's purchase payments may be subject to surrender charges for a longer period than they would be under a similar contract with no bonus credit; and
- ❑ Higher annual mortality and expense risk charges may be deducted for a variable annuity that pays a bonus credit. Although the difference may seem small, over time it can add up. In addition, some contracts may impose a separate fee specifically to pay for the bonus credit.

Before purchasing a variable annuity with a bonus credit, investors need to ask themselves whether the bonus is worth more to them than any increased charges they will pay for the bonus. This may depend on a variety of factors, including the amount of the bonus credit and the increased charges, how long the investor holds their annuity contract, and the return on the underlying investments. Investors also need to consider the other features of the annuity to determine whether it is a good investment.

Example.

Kyle makes purchase payments of \$10,000 in Annuity A and \$10,000 in Annuity B. Annuity A offers a bonus credit of 4% on his purchase payment, and deducts annual charges totaling 1.75%. Annuity B has no bonus credit and deducts annual charges totaling 1.25%. Let's assume that both annuities have an annual rate of return, prior to expenses, of 10%. By the tenth year, Kyle's account value in Annuity A will have grown to \$22,978. But his account value in Annuity B will have grown more, to \$23,136, because Annuity B deducts lower annual charges, even though it does not offer a bonus.

Investors should also note that a bonus may only apply to their initial premium payment, or to premium payments made within the first year of the annuity contract. Further, under some annuity contracts the insurer will take back all bonus payments made to an investor within the prior year or some other specified period if he or she makes a withdrawal, if a death benefit is paid to the investor's beneficiaries upon their death, or in other circumstances.

If someone already owns a variable annuity and is thinking of exchanging it for a different annuity with a bonus feature, they should be careful. Even if the surrender period on his or her current annuity contract has expired, a new surrender period generally will begin when they exchange that contract for a new one. This means that, by exchanging their contract, they will forfeit their ability to withdraw money from their account without incurring substantial surrender charges. And as described above, the schedule of surrender charges and other fees may be higher on the variable annuity with the bonus credit than they were on the annuity that he or she exchanged.

Example.

Courtney currently holds a variable annuity with an account value of \$20,000, which is no longer subject to surrender charges. She exchanges that annuity for a new variable annuity, which pays a 4% bonus credit and has a surrender charge period of eight years, with surrender charges beginning at 9% of purchase payments in the first year. Courtney's account value in this new variable annuity is now \$20,800. During the first year she holds the new annuity, she decides to withdraw all of her account value because of an emergency situation. Assuming that her account value has not increased or decreased because of investment performance, she will receive \$20,800 minus 9% of her \$20,000 purchase payment, or \$19,000. This is \$1,000 less than she would have received if she had stayed in the original variable annuity, where she was no longer subject to surrender charges.

In short, investors should take a hard look at bonus credits. In some cases, "bonus" may not be a good deal.

I. FINAL CONSIDERATIONS

Variable annuity contracts typically have a "free look" period of ten or more days, during which investors can terminate the contract without paying any surrender charges and get back their purchase payments (which may be adjusted to reflect charges and the performance of their investment). Individuals can continue to ask questions in this period to make sure they understand their variable annuity before the "free look" period ends.

Investors and their advisors should always consider the following questions before buying a variable annuity:

- ❑ Will the investor use the variable annuity primarily to save for retirement or a similar long-term goal?
- ❑ Is the individual investing in the variable annuity through a retirement plan or IRA (which would mean that they are not receiving any additional tax-deferral benefit from the variable annuity)?
- ❑ Is the individual willing to take the risk that their account value may decrease if the underlying mutual fund investment options perform badly?
- ❑ Does the individual understand the features of the variable annuity?
- ❑ Does the investor understand all of the fees and expenses that the variable annuity charges?
- ❑ Does the investor intend to remain in the variable annuity long enough to avoid paying any surrender charges if they have to withdraw money?
- ❑ If a variable annuity offers a bonus credit, will the bonus outweigh any higher fees and charges that the product may charge?
- ❑ Are there features of the variable annuity, such as long-term care insurance, that the individual could purchase more cheaply separately?
- ❑ Has the investor considered all the tax consequences of purchasing an annuity, including the effect of annuity payments on their tax status in retirement?
- ❑ If the investor exchanges one annuity for another one, do the benefits of the exchange outweigh the costs, such as any surrender charges that will have to be paid if they withdraw the money before the end of the surrender charge period for the new annuity?

CHAPTER 16 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Why is life insurance such a valuable part of estate planning:
 - a) proceeds are not subject to probate
 - b) proceeds are exempt from federal income tax
 - c) the price for coverage is generally reasonable
 - d) all of the above
2. Whole life insurance is traditionally cheaper than term life insurance.
 - a) true
 - b) false
3. Which of the following is not a characteristic of variable life insurance:
 - a) policy owners can borrow from their policy
 - b) allows the owner to accumulate cash tax-free
 - c) provides a fixed benefit upon death
 - d) allows the death benefit to increase
4. Universal life insurance allows the insured to adjust the amount of premiums to be paid, but not the death benefit of the policy.
 - a) true
 - b) false
5. Which of the following statements about variable annuities is not correct:
 - a) they pay only a one-time death benefit
 - b) they are commonly used as part of retirement planning
 - c) they provide choices in how the money is invested
 - d) owners receive periodic payments
6. An investor's most important source of information about a variable annuity's investment options is the prospectus.
 - a) true
 - b) false

7. Sellers of variable annuities never charge administrative fees.

- a) true
- b) false

8. The normal "free look" period for variable annuities is:

- a) three days or more
- b) ten days or more
- c) three weeks or more
- d) three months or more

CHAPTER 16 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The proceeds pass directly to the policy's beneficiary without being subject to probate. This is an important fact. However, this is not the best answer.

B: Incorrect. The benefits are generally not subject to federal income tax. However, this is not the best answer.

C: Incorrect. For the most part, term life insurance is fairly inexpensive, especially if it is purchased while the insured is still young. However, this is not the best answer.

D: Correct. All of the above reasons make life insurance an important component of virtually any estate plan.

(See page 16-1 of the course material.)

2. A: True is incorrect. Term insurance is traditionally the least expensive type of life insurance coverage.

B: False is correct. Term life insurance provides protection for a term of years and has no other value. It is therefore normally cheaper than whole life insurance, particularly when the insured is young.

(See page 16-2 of the course material.)

3. A: Incorrect. Owners can borrow from these policies during their lifetime.

B: Incorrect. The return on investments made by this type of insurance grows tax free for the owner.

C: Correct. This type of policy, by definition, is variable, meaning the death benefit will depend on the success of the investments.

D: Incorrect. This is true because the money paid for the policy is invested, giving the insured a chance to increase the value of the insurance over time.

(See pages 16-3 to 16-5 of the course material.)

4. A: True is incorrect. This type of insurance allows both to be adjusted.

B: False is correct. Universal life insurance allows the owner to adjust both the amount of premiums to be paid and the death benefits to be paid at their death. For example, the insured may choose to pay more in premiums before retirement and less after, when presumably their income would decrease.

(See page 16-5 of the course material.)

5. **A: Correct.** To the contrary, this type of financial planning tool gives the owner period income either immediately after the annuity is purchased or beginning at a fixed date in the future.

B: Incorrect. Given their flexibility, they have become a popular retirement tool in America.

C: Incorrect. Although the money is most commonly invested in mutual funds, there is a range of available investment options.

D: Incorrect. This makes them a popular retirement tool. Owners can also fix the date at which they begin receiving payments.

(See page 16-8 of the course material.)

6. **A: True is correct.** An investor's most important source of information about a variable annuity's investment options is the prospectus. Investors considering a variable annuity should request the prospectuses for the mutual fund investment options and read them carefully before allocating purchase payments among the investment options offered.

B: False is incorrect. There is no better source of information.

(See page 16-10 of the course material.)

7. A: True is incorrect. Administrative fees are just one of the common types of fees charged for variable annuities.

B: False is correct. The insurer may deduct charges to cover record keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps \$25 or \$30 per year) or as a percentage of the account value (typically in the range of 0.15% per year).

(See page 16-13 of the course material.)

8. A: Incorrect. The standard period is ten days or more.

B: Correct. This time allows investors to evaluate the annuity and cancel without paying surrender charges.

C: Incorrect. The typical period is only ten days or more.

D: Incorrect. This is significantly longer than the time normally given to cancel an annuity contract.

(See page 16-15 of the course material.)

Chapter 17: Trusts as a Financial Planning Tool

I. Introduction and Overview

Anyone engaged in financial or estate planning needs to consider the use of trusts as a way to reduce income taxes. Trusts are flexible and useful vehicles that can be used for many reasons, including tax planning, estate planning and for charitable giving. A trust may be created during the life of the donor (called an *inter vivos* trust) or at the death of the donor (called a *testamentary* trust). The person who creates the trust is most commonly referred to as the *trustor* of the trust. Other terms commonly used to denote the trustor are “settlor” and “donor.” These are merely terms of art, and no precise term is required in creating a valid trust. A trust can be either revocable (in which case the trustor is free to change his or her mind and retrieve the property within the trust) or irrevocable.

A. PROPER SUBJECTS OF A TRUST

Virtually anything can be the subject of a trust – real property, personal property such as a coin collection and furniture, as well as stocks, bonds, and other investment vehicles. The only significant limitation is that a trust cannot be used for an illegal purpose or to support an illegal activity, i.e. a trust to support domestic terrorism would be invalid.

B. PARTIES TO A TRUST

1. Trustee

The trustee is the individual who is in charge of managing the trust. Every trust must have a trustee. If for whatever reason the trustee cannot serve, however, the trust will not fail. Rather, an alternative trustee will be named either by a court, or, by the trust document itself if it contained the name of an alternate trustee. In a living trust, the trustor may be the trustee and the beneficiary.

The trustee owes a fiduciary duty to the trustor and the beneficiaries. The trustee's concern must be for the benefit of the beneficiary. This means that he or she must act in the best interest of the trustor. The specific powers of the trustee are either set forth in the trust document or provided for in accordance with applicable state law.

2. Beneficiary

The beneficiary or beneficiaries is the person or persons for whose benefit the trust was created. Without a beneficiary, the court cannot ascertain who should benefit from the trust. Nor is there a person who can enforce the obligations of the beneficiary. The beneficiary can be a specifically named individual or individuals or a class.

Example 1.

In his will, John creates a testamentary trust for the benefit of his sons, Roger, Emmitt and Michael. The proceeds are to be held in trust for the sons until they have all reached the age of 21. This is a trust in which the beneficiaries are specifically named.

Example 2.

In his will, John, who is childless, creates a testamentary trust for the benefit of "my nieces and nephews." Each niece and nephew is a beneficiary under the trust even though their names are not specifically used. This is referred to as a "class" gift.

3. Trust Property

To be valid, a trust must also have some identifiable trust property. No formal transfer of the property is required (with the exception of a requirement in some states where the subject of the trust is real property); a declaration is normally sufficient to change the nature of the property.

C. TITLE TO TRUST PROPERTY

The creation of a trust vests equitable title with the beneficiary or beneficiaries, while legal title is transferred to the trustee. The exception is testamentary trusts, which do not come into being until the death of the trustor. Title to property that is the subject to a testamentary trust remains with the trustor until his or her death. In the case of a revocable trust, title can be reclaimed by the trustor according to the terms of the trust instrument. The language of the trust document establishes the terms and conditions for the usage of the assets of the trust.

Example 1.

Jack created a trust for the benefit of his son, Roger, the proceeds of which were to pay for Roger's education. Any funds leftover at the end of his education were to be distributed to charity. Roger may not use the proceeds of the trust to buy a car, to take a vacation or to pay for a wedding. The limits are dictated by the language of the trust instrument.

Example 2.

Richard established a trust for the benefit of his wife, Lois, so long as his wife remained alive. After Lois' death, the proceeds are to be distributed to his children and grandchildren in equal amounts. Under the terms of this type of life interest, Lois is free to remain on and use the property, but is not free to dispose of or otherwise encumber it.

D. STATE LAW

State law plays an important role in governing the use of trusts. The formalities of trust creation differ from state to state and, to some extent, based upon the type of property that is the subject of the trust. In the case of real property, it is governed by the laws of the state in which the property is located. For example, in California and many other states, a trust that contains real property is not valid unless the trust is in writing. In the case of all other property, the law of the state of the trustor's domicile generally governs the trust. As always, refer to the laws of each state for more specific guidance.

II. Trust Creation

If a trustor establishes a trust through their will – a so-called testamentary trust – the trust provisions are contained in the will. If a trustor creates a will during his or her lifetime, its provisions will normally be contained in the trust document. Under some circumstances, no written document is required to create a trust so long as the trustor has declared the existence of the trust and transferred the trust property to the trustee, if required. As we said above, trusts are governed by state law. That means that anyone considering creating a trust should be familiar with the laws of their state of domicile. However, as an illustration, most states require each of the elements described below.

A. REQUIRED ELEMENTS

1. Precatory Language

Precatory language is an expression of the testator's wish. There must be a declaration – either orally or in writing – to create a valid trust. As a practical matter, oral trusts are never a good idea. Even if they are technically enforceable, any problems that might arise during its administration would be difficult to resolve absent a written document to provide guidance. As with a will, the trustor must have the requisite intent to create a trust in order for the document to be effective. This intent is set forth in the precatory language.

Example.

Roger, as part of his estate plan, drafted a living trust in which he was the primary beneficiary and his children, Bob and Brenda, were the contingent beneficiaries. The precatory language provides as follows: "I Roger Applebe, do hereby place all of my property, real and personal, in trust for my benefit during my lifetime and, at the end of my lifetime, for the benefit of my children Bob and Brenda." This language is a clear indication of Roger's intentions.

2. Writing Requirement

A trust that involves real property must generally be in writing. As we said above, however, it is a good idea to reduce any declaratory trust to writing in order to better protect the trustor's wishes.

3. Delivery

In most cases, no formal hand over of property is required to execute a valid trust. A mere declaration of trust normally, however, requires delivery of the trust property in order to be effective. In addition, the title to certain property often must be placed in the name of the trust, i.e. real property or motor vehicles in certain circumstances.

4. Knowledge of Beneficiary

It is not necessary for the validity of a voluntary trust that the beneficiary have knowledge of the existence of the trust or its provisions.

B. SELECTION OF TRUSTEE

1. Characteristics of Trustee

An important component of establishing a trust is selecting the trustee. In the case of a living trust, of course, the donor can also act as the trustee. When making plans for after the donor has passed, however, there are a number of important considerations, including the following:

- ☐ Is the trustee likely to carry out my wishes?
- ☐ Is the trustee financially responsible?
- ☐ Is the trustee knowledgeable in the area of investing and taxes?
- ☐ In the case of a spendthrift trust, is the trustee able to say “no” to demands from the beneficiary?

Key characteristics of any trustee are integrity and financial responsibility. A trustor is able to name more than one trustee to serve simultaneously. These people would be referred to as “co-trustees.” It is also generally a good idea to name an alternative trustee in the event the first one becomes unable or unwilling to serve.

2. Banks or Other Financial Institutions

Persons with particularly large estates often choose a bank to act as trustee. This can be advantageous because the entire institution, not a single person, is responsible for the assets. On the other hand, the service might be less personal than from someone with an emotional interest in the trustor or beneficiary. Banks and other financial institutions normally only handle trusts with a minimum worth, i.e. \$1 million. In addition, their fees may be higher than those charged by an individual.

C. FEES

The terms of a trust will normally set forth the fee, if any, the trustee is to receive for his or her services. Banks and other financial institutions generally set their own fees.

D. RULE AGAINST PERPETUAL TRUSTS

One significant limitation in the creation of a trust is the duration for which the trust is to last. With the exception of charitable trusts, state laws generally forbid trusts that last in perpetuity. Further limits were historically used in the rarely understood Rule Against Perpetuities.

E. NOTE ON PURE TRUSTS

A so-called pure trust is an arrangement that purports to create a separate entity without actually altering the taxpayer's control over the property or business transferred to the pure trust. Generally, the trust issues certificates that represent ownership of the trust. Often "pure trusts" are involved in arrangements to create a separate entity. The pure trust may be treated as a sham for federal tax purposes depending on the trust terms and its actual operation. Therefore, the taxpayer who transfers property or a business to the trust must report all the income earned by the trust and is liable for the taxes. The transferor may not circumvent the tax system by structuring transactions with the purpose of evading taxes.

III. Types of Common Trusts

There is no limit to the type of trusts that can be created or to the purposes for which they can be created. Accordingly, this section will provide a look into some of the more common types of trusts.

A. LIVING TRUSTS

Living trusts have been a fad in recent years. A living trust is simply a trust created during the lifetime of the trustor or donor in which the trustor is normally both the trustee and the beneficiary. This type of trust will also name a contingent beneficiary that will receive the assets of the trust at the trustor's death. Common reasons for establishing a living trust are as follows:

- ❑ Assets distributed through a valid trust are not subject to the time or expense often associated with probate; and
- ❑ A trust can be used as a "will substitute" if it accounts for all of the trustor's assets.

A living trust also acts to provide financial support to others without giving them control of the trust property.

Example.

Bill and Sally want to give financial help to their daughter, Elizabeth. Elizabeth is married to Mike, a compulsive gambler. Bill and Sally are certain that Mike will gamble away money given directly to Elizabeth. A trust may provide financial support to Elizabeth, while protecting the principal and income from Mike.

Table 17-1. Common Types of Trusts

Charitable Trusts	Created to support a charitable purpose or purposes; may be used to fund annual gifts during lifetime with remainder either going to charity or to other beneficiary.
Discretionary Trusts	Give trustee “discretion” to determine timing and amount of distributions.
Insurance Trusts	Trusts established by trustor prior to death and funded by life insurance proceeds after death.
Living Trusts	Created while trustor is still alive. Trustor can also act as trustee. This type of trust is generally revocable but can be irrevocable.
Medicaid Qualifying Trusts	Trusts in which certain assets are placed in trust to ensure that trustor is entitled to Medicaid benefits.
Pot Trusts	One in which there are multiple beneficiaries, each of which is entitled to support from the trust. If one beneficiary requires more support, they are entitled to receive it pursuant to the terms of the trust.
Revocable Trusts	One which can be changed or eliminated at the option of the trustor.
Irrevocable Trusts	One which cannot be changed once created.
Spendthrift Trusts	Limit the ability of beneficiaries to waste assets by limiting timing and amount of payments.
Support Trusts	Provide that income is to be used to meet certain basic needs of beneficiary, such as rent, or for educational support.
Totten Trusts	Not technically a trust; this is a type of pay-on-death account.
Wealth Trusts	Trusts used to reduce tax liabilities of later generations of beneficiaries.

1. Revocable Living Trusts

Most people who create this type of trust – also referred to as an *inter vivos* trust – make it revocable so that they can remove their assets from the trust if changed circumstances warrant such a decision. The effect of this type of trust is normally transparent for the individual who creates it. They continue to buy and sell assets as any other individual. However, in the case of real property and other assets, title must be held in the name of the trust. In some states, including California, a married person can only create a living trust with the participation of both spouses.

2. Protecting the Spouse Against Revocable Trusts

In many states, a living trust can only be created by the participation of both spouses because the transfer of the property is merely gratuitous. An elective share is not applicable in California because of the community property laws. In California, for example, there is no protection for a spouse as to the separate property of the other spouse.

3. Tax Implications

The living trust is unfortunately often hyped as a way to avoid estate and income taxes. While there may be some savings in income and gift taxes, as a general rule no one should consider a living trust as a way to avoid taxes.

In some cases, an irrevocable living trust can be used to shift income from high tax bracket taxpayers to lower bracket taxpayers, but only if the grantor trust rules are avoided. The irrevocable living trust can also be used to make gifts that qualify for the gift tax annual exclusion and reduce the taxable estate for estate tax purposes.

The potential income tax benefits of a living trust are obtained mainly by using irrevocable living trusts. If the grantor trust rules are avoided, the grantor is able to shift the income tax consequences of the trust to beneficiaries in a lower tax bracket. However, since the tax brackets for trusts were greatly compressed, using the trust entity as another taxpayer is usually not beneficial because the trust's income reaches the highest marginal tax rate much sooner.

The living trust can also be used to obtain estate tax benefits. The traditional credit shelter trust can provide the surviving spouse with an income interest and limited rights to access the corpus, while keeping the trust out of the surviving spouse's taxable estate at death.

There are some income tax benefits to having a probate estate. Individuals and trusts generally must choose a calendar year for the taxable year. The individual or trust must recognize income for tax purposes in the tax year in which it was earned. An estate, on the other hand, is able to pick a fiscal year as long as the fiscal year ends on the last day of a calendar month and does not exceed twelve months in length. This allows the estate to possibly defer the payment of income tax on estate distributions up to twenty-six months. If the taxpayer cannot eliminate or reduce the tax, this deferral of the tax is the next best option. Without a probate estate, no income tax deferral is possible.

In addition, estates do not have to make estimated income tax payments for two years after the death of the decedent. Trusts, on the other hand, are normally required to pay estimated taxes in the same manner as individuals, unless the trust is a grantor trust into which the residue of the decedent's estate will pass under the will. In that case, the trust receives the same two-year reprieve from paying estimated taxes that a probate estate receives. If no will is admitted to probate, then this rule will apply to the trust which is primarily responsible for paying taxes, debts, and administration expenses.

B. SUPPORT AND DISCRETIONARY TRUSTS

This type of trust is often used to provide for the needs of children, grandchildren or other family members without distributing the assets themselves. In some cases, the trustee is given discretion to determine the needs of the beneficiary. Once the trustee makes a decision to disburse funds in the trust, creditors can seize those assets except if the assets are held in a spendthrift trust. Such a trust protects the beneficiary from the reach of creditors. The majority of American courts hold valid spendthrift trusts.

In the United States, there is an exception to the validity of spendthrift trusts. Where the settlor and the beneficiary are the same person, the courts will not hold the spendthrift provision valid. Claims for child support and spousal support are allowed notwithstanding a spendthrift provision. Therefore, in a number of states, the law allows invasion of the spendthrift trust for spousal and child support.

C. CHARITABLE TRUSTS

Charitable trusts are created for the benefit of a certain organization or cause. This is the one type of trust that can be created to last forever.

1. Tax Deductible

A charitable gift is 100% tax deductible. Thus, the giving of a charitable gift saves both the amount of the gift in income from the donors other income sources as well as the extinction of the tax that would have been owed had the donor retained the charitable sum in his or her estate.

2. Valid Charitable Purpose

A charitable trust must have a valid charitable purpose. States have adopted legislation requiring the trustee of a charitable trust to file documentation regarding the trust with the state. Likewise, the statutes generally require the trustee to file periodic statements of the transactions of the trust.

3. Cy Pres Doctrine

With respect to most trusts, human greed assures the fulfillment of the trust. However, when charitable trusts are involved, there are generally no identifiable beneficiaries. The Cy Pres Doctrine allows the Attorney General of the state to prosecute the enforcement of the trust. In order for the Cy Pres doctrine to apply, three conditions must be met:

- ❑ The gift must be to a charitable organization for a charitable purpose;
- ❑ The gift must be impossible, impractical or illegal to carry out the donor's stated charitable purpose; and
- ❑ It must appear that the donor had a *general* charitable intent as opposed to a specific charitable intent.

4. Types of Charitable Trusts

There are various ways an individual who would like to leave money to charity can create a trust.

a. Charitable Remainder Trust

With this type of instrument, the donor transfers property to the trust and receives an immediate income tax deduction and avoids any capital gain taxes on donated appreciated property. In return, the donor receives an income stream generated by the trust assets either for a specified time or for life. At the end of that period, the charitable organization inherits the trust assets. The term of the trust must be for a life or lives or for a period of years not exceeding 20. At the end of the trust term the trust property belongs to one or more charitable organizations.

b. Charitable Lead Trust

This is an irrevocable trust with charitable and non-charitable beneficiaries in which the charitable beneficiaries receive either a fixed dollar amount each year (charitable lead annuity trust) or a fixed percentage of the value of the trust each year (charitable lead unitrust).

The term of the trust must be for a life or lives or for a term of years; at the end of the trust term, the trust property can revert to the grantor or belong to other non-charitable beneficiaries. It can be an effective technique to avoid percentage limitations on income tax charitable deductions or to reduce gift or estate taxes.

c. Charitable Remainder Annuity Trust

This is a charitable trust arrangement in which the donor or other beneficiary is paid annually an income of a fixed amount of at least 5% but not more than 50% of the initial fair market value of property placed in the trust. The term of the trust is for life or for a period of up to 20 years.

One or more qualified charitable organizations must be named to receive the remainder interest upon the death of the donor or other income beneficiaries. In addition, the value of the charitable remainder interest must be at least 10% of the net fair market value of all property transferred to the trust, as determined at the time of the transfer.

d. Charitable Remainder Unitrust

This is a charitable trust arrangement whereby the donor or other beneficiary is paid annually an income of a fixed percentage of at least 5% but not more than 50% of the annually revalued trust assets, either for life or for a period of up to 20 years.

One or more qualified charitable organizations must be named to receive the remainder interest upon the death of the donor or other income beneficiaries, and the value of the charitable remainder interest must be at least 10% of the net fair market value of all property transferred to the trust, as determined at the time of the transfer.

D. TESTAMENTARY TRUST

An individual can set up a testamentary trust in their will or direct certain assets from their estate to be put into a previously established trust. In the latter case, the will acts as a pour over will, as it pours certain assets into a trust. This type of “pour-over” will merely add the property to an already existing trust.

1. Reasons for Testamentary Trusts

There are several reasons individuals might consider a testamentary trust, including the following:

- ❑ To provide financial support for a surviving spouse while preserving the assets for children upon the death of the surviving spouse;
- ❑ To provide for the care of beneficiaries who are minors and therefore unable to manage the assets; and
- ❑ To care for incompetent beneficiaries, i.e. a mentally retarded child of the decedent.

2. Funding Testamentary Trusts

A trustor has many choices when planning how to fund a testamentary trust. Options include all of the following:

- ❑ Life insurance proceeds;
- ❑ Proceeds from the sale of a home;
- ❑ Pension benefits; or
- ❑ Proceeds from an individual retirement arrangement.

A number of factors, including estate tax issues, will affect the assets chosen to fund a testamentary trust.

E. IRREVOCABLE LIFE INSURANCE TRUST

The proceeds of a life insurance policy held in an individual's estate, perhaps used to pay for estate taxes, is subject to estate tax. But if an irrevocable life insurance trust owns the policy, the proceeds will not be included in the individual's estate. An individual may donate annually to the trust an amount equal to the premiums to pay for the policy. For these donations to qualify for the annual gift tax exclusion, the individual must use a complicated strategy called *Crummey* letters.

F. SPOUSAL TRUSTS

1. Bypass Trust

Special types of trusts are available to help spouses reduce estate taxes. A spouse (with the exception of a foreign-citizen spouse) can pass his or her entire estate tax free to the surviving spouse. For 2009, the exemption is \$3.5 million. But because the surviving spouse cannot make use of the deceased's exemption amount at his or her subsequent death, this "wastes" the deceased's exemption amount.

It is therefore often better for the first-to-die spouse to pass his or her exemption amount to a credit shelter trust. The surviving spouse can use income generated by the trust assets, and at the survivor's death, the assets pass to the trust's beneficiaries tax free. In addition, the estate of the second spouse also saves the additional exemption amount. Thus, for example, if both spouses died in 2008, they could exempt \$4 million between them instead of only \$2 million.

2. QTIP Trust

A provision of the Internal Revenue Code allows, as a marital deduction, a gift tax exemption of transfers of certain life estates to spouses. For the exemption to apply, the donor must create a Qualified Terminable Interest Property (QTIP) trust.

In general terms, transfers between spouses qualify for a marital deduction and thus are exempt from gift or estate tax. However, if the transfer is in the form of a life estate or other terminable interest, the marital deduction is generally not allowed. Additionally, there is an exception allowed under the gift tax for qualified terminable interest property. That interest is defined in § 2523(f)(1) as one "in which the donee spouse has a qualifying income interest for life, and to which an election under this subsection applies."

That election must be made "on or before the date prescribed by § 6075(b) (generally April 15 of the year following the transfer unless the period is properly extended) for filing a gift tax return with respect to the transfer." By regulation authorized under that provision, the election must be made on a timely filed gift tax return.

CHAPTER 17 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following statements about trusts is correct:
 - a) they are a useful tool in estate planning
 - b) they can be used for charitable giving
 - c) they can be important in tax planning
 - d) all of the above
2. To be valid, a trust must have some specific assets.
 - a) true
 - b) false
3. Which laws are most important in governing the creation and operation of trusts:
 - a) federal law alone
 - b) state law alone
 - c) state and federal law
 - d) state law to the extent that the value of the trust is under \$1 million and federal law for larger trusts
4. Which of the following traits are important when selecting a trustee:
 - a) a personal relationship with the trustor
 - b) financial responsibility
 - c) knowledge of investing and taxes
 - d) both b and c above
5. A common reason for establishing a living trust is that the assets distributed through the trust are not subject to the time or expense associated with probate.
 - a) true
 - b) false

6. What is the only trust that can be set up to last indefinitely:
- a) charitable trust
 - b) living trust
 - c) testamentary trust
 - d) bypass trust
7. The proceeds of a life insurance policy held in an individual's estate are not subject to estate tax.
- a) true
 - b) false

CHAPTER 17 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Both living trusts and testamentary trusts are important components of estate planning. However, this is not the best answer.

B: Incorrect. Charitable trusts can be used during the lifetime of the donor and after death. Charitable trusts are the only type that can be set up to last indefinitely. However, this is not the most correct answer.

C: Incorrect. Tax planning includes trusts intended to provide support to widows or widowers. However, this is not the most correct answer.

D: Correct. Trusts are an important component of estate and financial planning. They can be established during the lifetime of the trustor or upon death through a will.

(See page 17-1 of the course material.)

2. **A: True is correct.** Generally, no formal transfer of the property is required. Usually, a declaration is sufficient to change the nature of the property.

B: False is incorrect. For the trust property to be identifiable, generally a declaration is sufficient.

(See page 17-2 of the course material.)

3. A: Incorrect. While federal law is most significant in determining tax issues, state law is most significant when it comes to the creation and operation of trusts in all other respects.

B: Correct. For the most part, individual state laws govern how trusts are created as well as the details of their operation. Federal law is most important with respect to income tax issues.

C: Incorrect. Again, it is state law that controls this area of trusts.

D: Incorrect. There is no such distinction. State law governs the creation and operation of trusts, regardless of their size.

(See page 17-3 of the course material.)

4. A: Incorrect. Having a strong personal relationship does not necessarily mean the individual has the skill set and knowledge to be an effective or competent trustee.

B: Incorrect. Financial responsibility, including not giving in to demands of trust beneficiaries, is a very important trait for being a good trustee. However, this is not the best answer.

C: Incorrect. Knowledge of both investment and tax laws are key to growing the assets of the trust and keeping as much of that money as possible. However, this is not the best answer.

D: Correct. Both B and C are essential characteristics for a good trustee and are certainly more important than A.

(See page 17-4 of the course material.)

5. **A: True is correct.** A living trust also acts to provide financial support to others without giving them control of the trust property.

B: False is incorrect. Another reason for establishing a living trust is that it can be used as a “will substitute” if it accounts for all of the trustor’s assets.

(See page 17-5 of the course material.)

6. **A: Correct.** This type of trust, established for the benefit of a specific organization or cause, such as education or cancer research, is the only type capable of lasting forever.

B: Incorrect. By definition, a living trust lasts only so long as the trustor remains alive.

C: Incorrect. A testamentary trust becomes effective upon the death of the trustor, but it is not capable of lasting in perpetuity.

D: Incorrect. This type of trust that provides support for a surviving spouse ends when the surviving spouse dies.

(See page 17-8 of the course material.)

7. A: True is incorrect. If an irrevocable life insurance trust owns the policy, the proceeds will not be included in the individual’s estate.

B: False is correct. The proceeds of a life insurance policy can only be excluded from estate taxes if an irrevocable life insurance trust owns the policy.

(See page 17-10 of the course material.)

Chapter 18: Tax-Free Savings for Education

One objective of most people planning their estate is ensuring that adequate resources are available to help pay education costs of their heirs, notably their children and grandchildren. There are a number of options available to help meet this objective with substantial income tax savings. This chapter explains the tax benefits that may be available to individuals who are saving for or paying education costs for themselves or, in many cases, another student who is a member of their immediate family. Most benefits apply only to higher education. Also note that individuals generally cannot claim more than one of the benefits described in this chapter for the same qualifying education expense.

I. Coverdell Education Savings Accounts

A. OVERVIEW

Certain individuals are eligible to establish a Coverdell ESA to finance the qualified education expenses of a designated beneficiary. Until July 26, 2001, this type of account was called an education individual retirement arrangement (or Education IRA).

There is no limit to the number of separate Coverdell ESAs that can be established for a designated beneficiary. However, total contributions for the beneficiary in any year cannot be more than \$2,000, no matter how many accounts have been established. This benefit applies not only to higher education expenses, but also to elementary and secondary education expenses. Earnings on contributions will be distributed tax free, provided that they are used to pay the beneficiary's elementary or secondary school or college education expenses.

Table 18-1. Overview of Coverdell ESA

ISSUE	RULE
Type of Account	A savings account that is established to pay qualified educational expenses of a designated beneficiary.
Where It Can Be Established	At any bank in the United States or other IRS-approved entity that offers Coverdell ESAs.
Eligible Persons	Any beneficiary who is under the age of 18 or is a special needs beneficiary.
Persons Who Can Contribute	Generally, any individual including the beneficiary whose modified adjusted gross income for the year is less than \$110,000 (or \$220,000 in the case of a joint return).
Tax Treatment of Distributions	Distributions are tax free so long as they do not exceed the beneficiary's adjusted qualified expenses for the year.

Any individual who meets adjusted gross income (AGI) requirements can make a non-deductible contribution on behalf of a child under the age of 18. The AGI requirements are \$95,000 for single taxpayers and \$190,000 for married taxpayers. The \$2,000 annual contribution limit is phased out for single taxpayers with AGI of \$95,000 to \$110,000 and for joint filers with AGI of \$190,000 to \$220,000. Contributions to a Coverdell ESA may be made until the due date of the contributor's federal income tax return, without extensions.

Distributions are tax-free as long as they are used for qualified education expenses, such as tuition, books, fees, etc., at an eligible educational institution. This income exclusion is not available for any expenses for which the Hope Credit or the lifetime learning credit is claimed for that student. If the distribution exceeds education expenses, a portion will be taxable to the beneficiary and will be subject to a 10% tax penalty. Exceptions to the penalty include the death or disability of the beneficiary or if the beneficiary receives a qualified scholarship.

If there is a balance in the Coverdell ESA at the time the beneficiary reaches 30 years old, it must be distributed within 30 days. A portion representing earnings on the account will be taxable and subject to a 10% penalty. The beneficiary may avoid this tax and penalty by rolling over the full balance to another Coverdell ESA for another family member.

Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until distributed. If, for a year, distributions from an account are not more than a designated beneficiary's qualified education expenses at an eligible educational institution, the beneficiary will not owe tax on the distributions.

B. CREATION OF ACCOUNT

A Coverdell ESA is a trust or custodial account created or organized in the United States only for the purpose of paying the qualified education expenses of the designated beneficiary of the account. When the account is established, the designated beneficiary must be under age 18 or a special needs beneficiary. To be treated as a Coverdell ESA, the account must be designated as a Coverdell ESA when it is created. There are restrictions on how monies in the account can be invested. For example, the funds cannot be used to invest in life insurance contracts.

C. ELIGIBLE INSTITUTIONS

For purposes of Coverdell ESAs, an eligible educational institution can be either an eligible postsecondary school or an eligible elementary or secondary school.

1. Eligible Postsecondary School

This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell the investor if it is an eligible educational institution.

2. Eligible Elementary or Secondary School

This is any public, private, or religious school that provides elementary or secondary education (kindergarten through grade 12), as determined under state law.

D. QUALIFIED EXPENSES

Generally, these are expenses required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. For purposes of Coverdell ESAs, the expenses can be either qualified higher education expenses or qualified elementary and secondary education expenses. Eligible educational institutions can include both postsecondary schools and elementary and secondary schools.

1. Mandatory Expenses

The following expenses must be required for enrollment or attendance of a designated beneficiary at an eligible postsecondary school:

- ❑ Tuition and fees; and
- ❑ Books, supplies, and equipment.

Expenses for special needs services needed by a special needs beneficiary must be incurred in connection with enrollment or attendance at an eligible postsecondary school.

Expenses for room and board must be incurred by students who are enrolled at least half-time. The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts:

- ❑ The allowance for room and board, as determined by the school, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student; and
- ❑ The actual amount charged if the student is residing in housing owned or operated by the school.

2. Half-time Student

A student is enrolled “at least half-time” if he or she is enrolled for at least half the full-time academic work load for the course of study the student is pursuing, as determined under the standards of the school where the student is enrolled.

3. Qualified Elementary and Secondary Education Expenses

These are expenses related to enrollment or attendance at an eligible elementary or secondary school. As shown in the following list, to be qualified, some of the expenses must be required or provided by the school. There are special rules for computer-related expenses.

The following expenses must be incurred by a designated beneficiary in connection with enrollment or attendance at an eligible elementary or secondary school:

- ❑ Tuition and fees;
- ❑ Books, supplies, and equipment;
- ❑ Academic tutoring; and
- ❑ Special needs services for a special needs beneficiary.

The following expenses must be required or provided by an eligible elementary or secondary school in connection with attendance or enrollment at the school:

- ❑ Room and board;
- ❑ Uniforms;
- ❑ Transportation; and
- ❑ Supplementary items and services (including extended day programs).

The purchase of computer technology, equipment, or Internet access and related services is a qualified elementary and secondary education expense if it is to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school.

E. CONTRIBUTIONS

Any individual (including the designated beneficiary) can contribute to a Coverdell ESA if the individual's modified adjusted gross income (MAGI) for the year is less than \$110,000. For individuals filing joint returns, that amount is \$220,000. Organizations, such as corporations and trusts, can also contribute to Coverdell ESAs. There is no requirement that an organization's income be below a certain level.

1. Contribution Requirements

Contributions must meet all of the following requirements:

- ❑ They must be in cash;
- ❑ They cannot be made after the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary; and
- ❑ They must be made by the due date of the contributor's tax return (not including extensions).

Contributions can be made to one or several Coverdell ESAs for the same designated beneficiary provided that the total contributions are not more than the contribution limits for a year. Contributions can be made, without penalty, to both a Coverdell ESA and a QTP in the same year for the same beneficiary.

2. Contribution Limits

There are two yearly limits:

- ❑ One on the total amount that can be contributed for each designated beneficiary in any year; and
- ❑ One on the amount that any individual can contribute for any one designated beneficiary for a year.

3. Limit for Each Designated Beneficiary

For 2008, the total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary could not be more than \$2,000. This includes contributions (other than rollovers) to all the beneficiary's Coverdell ESAs from all sources.

Example.

When Maria Luna was born in 2007, three separate Coverdell ESAs were set up for her, one by her parents, one by her grandfather, and one by her aunt. In 2008, the total of all contributions to Maria's three Coverdell ESAs cannot be more than \$2,000. For example, if her grandfather contributed \$2,000 to one of her Coverdell ESAs, no one else could contribute to any of her three accounts. Or, if her parents contributed \$1,000 and her aunt \$600, her grandfather or someone else could contribute no more than \$400. These contributions could be put into any of Maria's Coverdell ESA accounts.

4. Limit for Each Contributor

Generally, individuals can contribute up to \$2,000 for each designated beneficiary for 2008. This is the most that can be contributed for the benefit of any one beneficiary for the year, regardless of the number of Coverdell ESAs set up for the beneficiary.

Example.

The facts are the same as in the previous example except that Maria Luna's older brother, Edgar, also has a Coverdell ESA. If their grandfather contributed \$2,000 to Maria's Coverdell ESA in 2008, he could also contribute \$2,000 to Edgar's Coverdell ESA.

5. Reduced Limit

Certain individuals are subject to a reduced contribution limit. If an individual's modified adjusted gross income (MAGI) (defined below) is between \$95,000 and \$110,000 (between \$190,000 and \$220,000 if filing a joint return), the \$2,000 limit for each designated beneficiary is gradually reduced. If their MAGI is \$110,000 or more (\$220,000 or more if filing a joint return), they cannot contribute to anyone's Coverdell ESA.

Table 18-2. Coverdell ESA Contributions

ISSUE	RULE
Deductibility	Contributions are not tax deductible.
Benefit of Contributing	Earnings in the account grow tax free until they are distributed.
Annual Contribution Limit	\$2,000 for each designated beneficiary.
Effect of Multiple Accounts	The annual contribution limit is \$2,000 for each beneficiary regardless of the number of accounts that are set up for the beneficiary.
Effect of Multiple Contributors	The annual contribution limit is \$2,000 per beneficiary, no matter how many individuals contribute.
Type of Contributions	Only cash can be contributed to a Coverdell ESA. No other type of property or assets can be contributed.
Timing of Contributions	No contributions can be made to a beneficiary's Coverdell ESA after he or she reaches age 18, unless the beneficiary is a special needs beneficiary.

F. ADDITIONAL TAX ON EXCESS CONTRIBUTIONS

The beneficiary must pay a 6% excise tax each year on excess contributions that are in a Coverdell ESA at the end of the year. Excess contributions are the total of the following two amounts:

- ❑ Contributions to any designated beneficiary's Coverdell ESA for the year that are more than \$2,000; and
- ❑ Excess contributions for the preceding year, reduced by the total of the following two amounts:
 - Distributions (other than those rolled over as discussed later) during the year; and
 - The contribution limit for the current year minus the amount contributed for the current year.

G. ROLLOVERS AND OTHER TRANSFERS

Assets can be rolled over from one Coverdell ESA to another. The designated beneficiary can be changed or the beneficiary's interest can be transferred to a spouse or former spouse because of divorce.

1. Rollovers

Any amount distributed from a Coverdell ESA and rolled over to another Coverdell ESA for the benefit of the same beneficiary or a member of the beneficiary's family (including the beneficiary's spouse) who is under age 30 is not taxable. An amount is rolled over if it is paid to another Coverdell ESA within 60 days after the date of the distribution. For these purposes, the beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary:

- ☐ Son or daughter or descendant of son or daughter;
- ☐ Stepson or stepdaughter;
- ☐ Brother, sister, stepbrother, or stepsister;
- ☐ Father or mother or ancestor of either;
- ☐ Stepfather or stepmother;
- ☐ Son or daughter of a brother or sister;
- ☐ Brother or sister of father or mother;
- ☐ Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;
- ☐ The spouse of any individual listed above; or
- ☐ First cousin.

Only one rollover per Coverdell ESA is allowed during the 12-month period ending on the date of the payment or distribution.

2. Changing the Designated Beneficiary

The designated beneficiary can be changed to a member of the beneficiary's family (defined above). There are no tax consequences if, at the time of the change, the new beneficiary is under age 30.

3. Transfer Because of Divorce

If a spouse or former spouse receives a Coverdell ESA under a divorce or separation instrument, it is not a taxable transfer. After the transfer, the spouse or former spouse treats the Coverdell ESA as his or her own.

H. DISTRIBUTIONS

The designated beneficiary of a Coverdell ESA can take a distribution at any time. Whether the distributions are tax free depends, in part, on whether the distributions are equal to or less than the amount of adjusted qualified education expenses that the beneficiary has in the same tax year. Distributions are not subject to tax so long as they

do not exceed the designated beneficiary's qualified educational expenses for the year. This calculation takes into account any tax-free education assistance the beneficiary may have received, such as government grants or employer-provided educational assistance.

Table 18-3. Coverdell ESA Distributions

ISSUE	RULE
Taxation of Distribution	Generally, a distribution from a Coverdell ESA to pay for a designated beneficiary's qualified education expenses is tax free to the extent it does not exceed the beneficiary's qualified educational expenses.
Distribution of Remaining Assets	After the designated beneficiary completes his or her education at an eligible institution, the remaining assets in the account can generally be distributed. However, the amounts must be distributed when the designated beneficiary reaches age 30, unless he or she is a special needs beneficiary. Also, certain transfers to members of the beneficiary's family are permitted.
Eligibility for Tax-Free Distribution	The designated beneficiary does not need to be enrolled for a minimum number of courses to take a tax-free distribution.

A portion of the distributions is generally taxable to the beneficiary if the distributions are more than the beneficiary's adjusted qualified education expenses for the year.

I. COORDINATION WITH LEARNING CREDITS

Certain federal tax credits, i.e. the Hope or lifetime learning credit, can be claimed in the same year the beneficiary takes a tax-free distribution from a Coverdell ESA, as long as the same expenses are not used for both benefits. This means the beneficiary must reduce qualified higher education expenses by tax-free educational assistance, and then further reduce them by any expenses taken into account in determining a Hope or lifetime learning credit.

J. COORDINATION WITH QUALIFIED TUITION PROGRAM DISTRIBUTIONS (QTP)

If a designated beneficiary receives distributions from both a Coverdell ESA and a QTP in the same year, and the total distribution is more than the beneficiary's adjusted qualified higher education expenses, those expenses must be allocated between the distribution from the Coverdell ESA and the distribution from the QTP before figuring how much of each distribution is taxable.

K. ADDITIONAL TAX ON TAXABLE DISTRIBUTIONS

Generally, if an individual receives a taxable distribution, they also must pay a 10% additional tax on the amount included in income. The 10% additional tax does not apply to distributions:

- ❑ Paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary;
- ❑ Made because the designated beneficiary is disabled. A person is considered to be disabled if he or she shows proof that he or she cannot do any substantial gainful activity because of his or her physical or mental condition. A physician must determine that his or her condition can be expected to result in death or to be of long-continued and indefinite duration;
- ❑ Included in income because the designated beneficiary received:
 - A tax-free scholarship or fellowship;
 - Veterans' educational assistance;
 - Employer-provided educational assistance; or
 - Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.
- ❑ Made on account of the attendance of the designated beneficiary at a U.S. military academy (such as West Point). This exception applies only to the extent that the amount of the distribution does not exceed the costs of advanced education (as defined in title 10 of the U.S. Code) attributable to such attendance;
- ❑ Included in income only because the qualified education expenses were taken into account in determining the Hope or lifetime learning credit; or
- ❑ Made before June 1, 2008, of an excess 2007 contribution (and any earnings on it). The distributed earnings must be included in gross income for the year in which the excess contribution was made.

L. WHEN ASSETS MUST BE DISTRIBUTED

Any assets remaining in a Coverdell ESA must be distributed when either one of the following two events occurs:

- ❑ The designated beneficiary reaches age 30. In this case, the remaining assets must be distributed within 30 days after the beneficiary reaches age 30. However, this rule does not apply if the beneficiary is a special needs beneficiary; or

- ❑ The designated beneficiary dies before reaching age 30. In this case, the remaining assets must generally be distributed within 30 days after the date of death.

If a Coverdell ESA is transferred to a surviving spouse or other family member as the result of the death of the designated beneficiary, the Coverdell ESA retains its status. This means the spouse or other family member can treat the Coverdell ESA as his or her own and does not need to withdraw the assets until he or she reaches age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary. There are no tax consequences as a result of the transfer.

When a total distribution is made because the designated beneficiary either reached age 30 or died, the earnings that accumulated tax free in the account must be included in taxable income.

II. Other Education Savings Accounts

A. QUALIFIED TUITION PROGRAM (QTP)

A Qualified Tuition Program, also known as a 529 college savings plan, is a type of investment account that allows individuals to set aside money for their child's education. The money is then able to grow tax-free. The proceeds of the account are not subject to federal income tax so long as the funds are used for higher education. Unlike other types of college savings programs, any family can contribute to a 529 account regardless of income. The account is subject to a lifetime maximum contribution of roughly \$300,000 (this varies from state to state).

The money in a 529 plan can be used at any accredited college or university in the country – public or private, graduate or undergraduate. The money can be used for tuition, fees, room and board, books, supplies, and equipment. All 529 plans are administered by individual states. While individuals are not required to invest in their state of domicile, there are normally additional advantages for doing so.

1. Tax Benefits

The primary tax benefit is that no tax is due on a distribution from a state-sponsored QTP unless the amount distributed is greater than the beneficiary's adjusted qualified education expenses. In addition, even if a QTP is used to finance a student's education, the student or the student's parents still may be eligible to claim either the Hope credit or the lifetime learning credit.

In addition, funds contributed to a 529 plan are not considered in assessing a student's eligibility for financial assistance. The following are some of the advantages to a 529 plan.

Money invested in the account remains tax free as long as it is kept in the program. When money is taken out for educational expenses, investors will not pay federal taxes on either the principal or income. State tax treatment varies, although most states also do not tax withdrawals.

Another potential tax benefit of this savings option is that if an individual has a loss on their investment in a QTP account, they may be able to take the loss on their income tax return. A taxpayer can take the loss only when all amounts from that account have been distributed and the total distributions are less than their unrecovered basis. An individual's basis is the total amount of contributions to that QTP account. A taxpayer must claim the loss as a miscellaneous itemized deduction.

2. Contributions Considered a Gift

The money invested in a 529 account is considered a gift and, as a result, qualifies for the annual \$12,000 gift tax exclusion. In addition, federal law allows individuals to contribute up to five years' worth of gifts in one year without incurring gift tax liability so long as no further proceeds are contributed over the following four years.

Example.

Randy and Ethel have one grandson, John. John is preparing to go to college in the fall. Randy and Ethel have not put any funds aside for the benefit of their grandson, but are now realizing that they need to reduce the size of their estate. They decide to place \$60,000 in one year in a 529 plan account for the benefit of John. This allows them to reduce the size of their taxable estate by \$60,000 and jump start an investment for their grandson's higher education.

3. Control of Funds

Investors in a 529 plan can decide when and how much money to withdraw. Unlike certain types of custodial accounts, the beneficiary of the account does not attain control upon reaching a certain age, i.e. 18 or 21.

4. Flexibility

Individuals can open a 529 plan for themselves or someone else regardless of age. If a child or other beneficiary elects not to attend college or does not need all of the money invested, the funds can be rolled over for someone else's benefit.

Example.

Steve and his wife Catherine have four children, Katie, who is 4, and triplets who are 1. Steve and Catherine open a 529 plan for their oldest daughter and contribute the maximum amount allowed. By the time Katie is ready for college, the value of the fund is \$350,000. Because Katie is brilliant, she is able to attend Stanford University on a full scholarship. Steve and Catherine are then able to use the proceeds from the account to pay for the education of their triplets, who each choose to attend expensive Ivy League colleges.

A 529 plan is not, of course, perfect. Investors are limited to the investment vehicles offered by the state sponsors of the program. In addition, funds from a 529 plan withdrawn and used for non-educational expenses are subject to a 10 percent penalty in addition to federal income taxes on earnings. Some states also apply a 10 percent tax.

5. Qualified Education Expenses

These expenses are the tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. They also include the reasonable costs of room and board for a designated beneficiary who is at least a half-time student. The definition of qualified education expenses was expanded in 2002 to include expenses of a special needs beneficiary that are necessary for that person's enrollment or attendance at an eligible educational institution.

6. Designated Beneficiary

The designated beneficiary is generally the student (or future student) for whom the QTP is intended to provide benefits. The designated beneficiary can be changed after participation in the QTP begins. If a state or local government or certain tax-exempt organizations purchase an interest in a QTP as part of a scholarship program, the designated beneficiary is the person who receives the interest as a scholarship.

7. Amounts That Can Be Contributed

Contributions to a QTP on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified education expenses of the beneficiary. There are no income restrictions on the individual contributors. Individuals may contribute to both a QTP and a Coverdell ESA in the same year for the same designated beneficiary.

8. Tax Treatment of Distributions

The part of a distribution representing the amount paid or contributed to a QTP does not have to be included in income. This is a return of the investment in the plan. The designated beneficiary generally does not have to include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the total distribution is less than or equal to adjusted qualified education expenses. However, until 2004, the beneficiary must include in income any earnings distributed from a QTP established and maintained by an eligible educational institution.

9. Coordination With Hope and Lifetime Learning Credits

A Hope or lifetime learning credit (education credit) can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP, as long as the same expenses are not used for both benefits. This means that after the beneficiary reduces qualified education expenses by tax-free educational assistance, he or she must further reduce them by the expenses taken into account in determining the credit.

10. Coordination With Coverdell ESA Distributions

If a designated beneficiary receives distributions from both a QTP and a Coverdell ESA in the same year, and the total of these distributions is more than the beneficiary's adjusted qualified education expenses, the expenses must be allocated between the distributions.

11. Rollovers and Other Transfers

Assets can be rolled over or transferred from one QTP to another. The designated beneficiary can be changed or the beneficiary's interest can be transferred to a spouse or former spouse because of divorce. In addition, any amount distributed from a QTP and rolled over to another QTP for the benefit of the same beneficiary or for the benefit of a member of the beneficiary's family (including the beneficiary's spouse) is not taxable. An amount is rolled over if it is paid to another QTP within 60 days after the date of the distribution.

For these purposes, the beneficiary's family includes the beneficiary's spouse and other designated relatives of the beneficiary, including a spouse, parents, children, and siblings. Only one rollover per QTP is allowed during the 12-month period ending on the date of the payment or distribution.

There are no tax consequences if the designated beneficiary of an account is changed to a member of the beneficiary's family.

B. IRA WITHDRAWAL

As of January 1, 1998, individuals may make withdrawals from an individual retirement account (IRA) to pay the qualified higher education expenses for the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer or taxpayer's spouse at an eligible educational institution.

The taxpayer will owe federal income tax on the amount withdrawn, but will not be subject to the 10 percent early withdrawal tax that applies when amounts are withdrawn from an individual retirement account before the account holder reaches age 59½.

The 10 percent early withdrawal tax does not apply to a distribution from an IRA to the extent that the amount of the distribution does not exceed the qualified higher education expenses for the taxpayer, the taxpayer's spouse, and the child or grandchild of the taxpayer or the taxpayer's spouse at an eligible educational institution. For purposes of this rule, the term "qualified higher education expenses" means tuition, fees, books, supplies and equipment required for the enrollment or attendance of the student at an eligible educational institution. Qualified higher education expenses also include room and board if the student is enrolled at least half-time.

Qualified higher education expenses paid with an individual's earnings, a loan, a gift, an inheritance given to the student or the individual claiming the credit, or personal savings (including savings from a qualified state tuition program) are included in determining the amount of the IRA withdrawal which is not subject to the 10 percent early withdrawal tax. Qualified higher education expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are excluded.

In addition, individuals can make a withdrawal from a Roth IRA, as they can from other IRAs, to pay qualified higher education expenses without paying the 10 percent early withdrawal tax.

III. Savings Bonds for Education

Generally, individuals must pay tax on the interest earned on U.S. savings bonds. If the individual does not include the interest in income in the years it is earned, they must include it in their income in the year in which the bonds are cashed in. However, when an individual cashes in certain savings bonds under an education savings bond program, they may be able to exclude interest from income.

An individual may be able to cash in qualified U.S. savings bonds without having to include in income some or all of the interest earned on the bonds if the following conditions are met:

- ❑ The individual pays qualified education expenses for themselves, their spouse, or a dependent for whom they claim an exemption on their return;
- ❑ Their modified adjusted gross income (MAGI) in 2008 is less than \$82,100 (\$130,650 if filing a joint return); and
- ❑ Their filing status is not married filing separately.

A. QUALIFIED U.S. SAVINGS BONDS

A qualified U.S. savings bond is a series EE bond issued after 1989 or a series I bond. The bond must be issued either in the individual's name (as the sole owner) or in the name of both the individual and their spouse (as co-owners). The owner must be at least 24 years old before the bond's issue date. The issue date is printed on the front of the savings bond. The issue date is not necessarily the date of purchase – it will be the first day of the month in which the bond is purchased.

B. QUALIFIED EDUCATIONAL EXPENSES

Qualified education expenses include the following:

- ❑ Tuition and fees required to enroll at or attend an eligible educational institution. Qualified education expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree or certificate granting program;
- ❑ Contributions to a qualified tuition program (QTP); and
- ❑ Contributions to a Coverdell education savings account (ESA), formerly known as an education IRA.

C. ELIGIBLE EDUCATIONAL INSTITUTION

An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

D. FIGURING THE TAX-FREE AMOUNT

If the total an individual receives when they cash in the bonds is not more than the adjusted qualified education expenses for the year, all of the interest on the bonds may be tax free. However, if the total received when the bonds are cashed in is more than the adjusted expenses, only part of the interest may be tax-free.

Example.

In February 2008, Mark and Joan Washington, a married couple, cashed a qualified series EE U.S. savings bond. They received proceeds of \$9,000, representing principal of \$6,000 and interest of \$3,000. In 2008, they paid \$7,650 of their daughter's college tuition. They are not claiming a Hope or lifetime learning credit for that amount, and their daughter does not have any tax-free educational assistance. Their MAGI for 2008 was \$80,000.

\$3,000	x \$7,650 expenses	=	\$2,550 tax free
interest	\$9,000 proceeds		interest

They can exclude \$2,550 of interest in 2008. They must pay tax on the remaining \$450 (\$3,000 - \$2,550) interest.

E. EFFECT OF THE AMOUNT OF INCOME ON EXCLUSION

For 2008, for example, the amount of an individual's interest exclusion is gradually reduced (phased out) if their modified adjusted gross income was between \$67,100 and \$82,100 (between \$100,650 and \$130,650 if their filing status is married filing jointly or qualifying widow(er)). They cannot exclude any of the interest if their modified adjusted gross income is equal to or more than the upper limit.

IV. Tax Credits for Education

There are two tax credits available to help individuals offset the costs of higher education. They are the Hope credit and the lifetime learning credit, also referred to as education credits. Only one of the credits can be elected each year for each student.

A. HOPE CREDIT

The Hope credit is a nonrefundable tax credit, not a scholarship or tax deduction. Tax credits are subtracted directly from the tax a family or student owes, while tax deductions are subtracted from taxable income. To receive the Hope tax credit, a family or student must file a federal tax return and owe taxes. Families and students that do not

pay taxes cannot receive money from the Hope credit. If a family or student owes less in taxes than the amount of Hope tax credit they are eligible for, they can only receive a credit equal to the amount of taxes owed.

For the 2008 tax year, a family or student can claim up to \$1,800 (\$3,600 for students in a Midwestern disaster area) for each eligible student for up to two tax years (100% of the first \$1,200 (\$2,400 for students in a Midwestern disaster area) and 50% of the second \$1,200 (\$2,400 for students in a Midwestern disaster area) paid for qualified expenses). The Hope credit is only available until each student's first two years of postsecondary education are complete.

The exact amount of the Hope credit also depends on a family's income, the amount of qualified tuition and fees paid, and the amount of certain scholarships and allowances subtracted from tuition. The total credit is also based on how many eligible students are in a family. This differs from the lifetime learning credit which sets a maximum dollar amount for a family.

1. Qualifications

An eligible taxpayer must file a federal tax return and owe taxes to claim the Hope credit. The taxpayer must also claim an eligible student as a dependent on the tax return, unless the credit is for the taxpayer or the taxpayer's spouse. (This means the eligible taxpayer may also be the eligible student.) In 2008, taxpayers cannot claim a Hope credit if their modified adjusted gross income (AGI) is \$58,000 or more for a single taxpayer (\$116,000 or more for those filing a joint return). The Hope credit amount is reduced gradually for families with incomes between \$48,000 and \$58,000 (\$96,000 and \$116,000 for joint returns). AGI limits were increased by \$1,000 for single taxpayers (\$2,000 for those filing jointly) in the 2008 tax year.

An eligible student must be enrolled at least half-time for at least one academic period beginning in 2008 at an eligible program leading to a degree or certificate at an eligible school and cannot have completed the first two years of undergraduate study. You may claim the credit yourself if you are not claimed as a dependent by another taxpayer. (Once again, this means that the eligible student may also be the eligible taxpayer.) Students convicted of a federal or state drug felony before the end of 2008 are not eligible for the Hope credit.

2. Application Process

To apply for the credit, taxpayers must report the amount of qualified tuition and fees paid as well as the amount of certain scholarships, grants, and untaxed income used to pay tuition and fees in 2008. Schools are required to send this information to each taxpayer and to the IRS by January 31, 2009, in the form of a 1098-T statement. Taxpayers use this information and their own records about tuition and fees paid when they fill out IRS form 8863 to claim the tax credit. The statement sent by the school will also include contact information for someone at the school who can answer questions about the information on the form. A taxpayer may wish to talk to a tax advisor for help in calculating the amount of the credit.

3. When Credit Is Available

Generally, the credit is allowed for qualified education expenses paid in 2008 for an academic period that begins in 2008 or during the first three months of 2009 (e.g., paying in December 2008 for an academic period beginning in the first three months of 2009).

4. Multiple Benefits

A family may claim a lifetime learning credit, a Hope credit, and an exclusion from gross income for certain distributions from qualified state tuition programs or education IRAs as long as the same student is not used as the basis for each credit or exclusion and the family doesn't exceed the lifetime learning maximum per family.

5. Income Limits

The amount of a Hope Credit for 2008 is gradually reduced (phased out) for those with modified adjusted gross incomes (AGI) between \$48,000 and \$58,000 (\$96,000 and \$116,000 for joint returns). Those with a modified AGI of \$58,000 or more (\$116,000 for joint returns) cannot claim a Hope credit. Beginning in 2008, the amount of the Hope credit (per eligible student) is the sum of:

- ❑ 100% of the first \$1,200 of qualified education expenses paid for the eligible student (\$2,400 for students in a Midwestern disaster area); and
- ❑ 50% of the next \$1,200 of qualified education expenses paid for that student (\$2,400 for students in a Midwestern disaster area).

The maximum Hope credit increased \$150 in 2008 to \$1,800 per student (\$3,600 for students in Midwestern disaster areas) - up from \$1,650 in 2007. Congress extended this tax benefit until December 31, 2009 as part of the \$700 billion economic stimulus package.

B. LIFETIME LEARNING CREDIT

The lifetime learning credit is a nonrefundable tax credit available to individuals who file a tax return and owe taxes. The amount of the credit is subtracted from the taxes owed, rather than reducing taxable income as with a tax deduction. Individuals who do not pay taxes are not eligible for a lifetime learning credit. If a taxpayer owes less in taxes than the amount of lifetime learning credit they are eligible for, they are only eligible for a credit equal to the amount of taxes they owe.

A family may claim a tax credit of up to \$2,000 per tax year for the taxpayer, taxpayer's spouse, or any eligible dependents for an unlimited number of tax years. The amount of the lifetime learning credit is 20% of the first \$10,000 of qualified educational expenses paid for all eligible students. Therefore, the maximum amount of a lifetime learning credit is \$2,000. The lifetime learning credit is available for all years of postsecondary education and for courses taken to acquire or improve job skills, unlike the Hope credit which is only available for two years.

The actual amount of the credit depends on a family's income, the amount of qualified tuition and fees paid, and the amount of certain scholarships and allowances subtracted from tuition. This credit is family-based (up to \$2,000 per tax return), unlike the Hope credit which is based on the number of eligible dependents in a family.

1. Qualifications

The Taxpayer: An eligible taxpayer must file a tax return and owe taxes to claim the credit. The taxpayer must also claim the eligible student as a dependent unless the credit is for the taxpayer or the taxpayer's spouse. (This means the eligible taxpayer may also be the eligible student.) In 2008, those with a modified Adjusted Gross Income (AGI) of \$58,000 or more (if single), or \$116,000 or more (for married taxpayers filing a joint return) cannot claim a lifetime learning credit. AGI limits were increased by \$1,000 for single taxpayers and \$2,000 married taxpayers for the 2008 tax year. The lifetime learning credit amount is reduced gradually for families with incomes between \$48,000 and \$58,000 if single, or \$96,000 and \$116,000 if married and filing jointly. Taxpayers that claim the Hope credit or tuition and fees deduction for a student are not eligible to claim the lifetime learning credit for the same student.

An eligible student may be enrolled in an eligible program leading to an undergraduate or graduate degree at an eligible school during the calendar year OR may be enrolled in any course of instruction at an eligible school to acquire/improve the student's job skills during the calendar year. Students may claim the credit themselves if they are not claimed as a dependent by another taxpayer. (Once again, this means that the eligible student may also be the eligible taxpayer.)

2. Claiming the Credit

To apply for the credit, the taxpayer must report the amount of qualified tuition and fees paid as well as the amount of certain scholarships, grants, and untaxed income used to pay the tuition and fees. Schools must send this information to taxpayers and to the IRS by January 31, 2009, in the form of a 1098-T statement. Taxpayers will use this information and their own records about tuition and fees paid when they fill out the IRS Form 8863 to claim the tax credit. The statement sent by the school will also include contact information for someone at the school who can answer questions about the information on the form. A taxpayer may wish to talk to a tax advisor for help in calculating the amount of its credit.

Generally, the deduction is allowed for qualified tuition and expenses paid in 2008 in connection with enrollment at an institution of higher education during 2008 or for an academic period beginning in 2008 or in the first three months of 2009. For instance, if you paid \$1,500 in December 2008 for qualified tuition for a spring 2008 semester that begins in January 2009, that \$1,500 can be used to figure the 2008 deduction.

3. Multiple Benefits

A family may claim a lifetime learning credit, a Hope credit, and an exclusion from gross income for certain distributions from qualified state tuition programs or education IRAs as long as the same student is not used as the basis for each credit or exclusion AND the family does not exceed the lifetime learning maximum per family.

4. Increased Income Limits

The amount of a lifetime learning credit for 2008 is gradually reduced (phased out) for those with modified adjusted gross incomes (AGI) between \$48,000 and \$58,000 (\$96,000 and \$116,000 for joint returns). Those with a modified AGI of \$58,000 or more (\$116,000 for joint returns) cannot claim a Hope credit.

Table 18-4. Comparison of Education Credits

LIFETIME LEARNING CREDIT	HOPE CREDIT
Up to \$2,000 (\$4,000 if a student in a Midwestern disaster area) credit per return	Up to \$1,800 (\$3,600 if a student in a Midwestern disaster area) credit per eligible student
Available for all years of postsecondary education and for courses to acquire or improve job skills	Available ONLY until the first 2 years of post- secondary education are completed
Available for an unlimited number of years	Available ONLY for 2 years per eligible student
Student does not need to be pursuing a degree or other recognized education credential	Student must be pursuing an undergraduate degree or other recognized education credential
Available for one or more courses	Student must be enrolled at least half time for at least one academic period beginning during the year
Felony drug conviction rule does not apply	No felony drug conviction on student's record

Table 18-5. Claiming a Dependent's Exemption

IF a taxpayer...	THEN only...
Claims an exemption on their tax return for a dependent who is an eligible student	They can claim the lifetime learning credit based on that dependent's expenses. The dependent cannot claim the credit.
Does not claim an exemption on their tax return for a dependent who is an eligible student (even if entitled to the exemption)	the dependent can claim the lifetime learning credit. The taxpayer cannot claim the credit based on this dependent's expenses.

V. Scholarships, Fellowships, Grants, and Tuition Reductions

This section discusses the taxability of various types of educational assistance the individual may receive if they are studying, teaching, or researching in the United States. Included in the discussion are:

- ☐ Scholarships;
- ☐ Fellowships;
- ☐ Need-based education grants, such as a Pell Grant; and
- ☐ Qualified tuition reductions.

Many of these amounts are tax free if they meet the requirements discussed here.

A. SCHOLARSHIPS AND FELLOWSHIPS

A scholarship is generally an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of studies. The student may be either an undergraduate or a graduate student. A fellowship is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research.

Table 18-6. Taxability of Scholarships and Fellowships

IF you use the payment for...	AND you are...		THEN your payment is...	
	A degree candidate	Not a degree candidate	Tax free ¹	Taxable
Tuition	X		X	
		X		X
Fees	X		X ²	
		X		X
Books	X		X ²	
		X		X
Supplies	X		X ²	
		X		X
Equipment	X		X ²	
		X		X
Room	X			X
		X		X
Board	X			X
		X		X
Travel	X			X
		X		X
Teaching	X			X ³
		X		X
Research services	X			X ³
		X		X
Other services	X			X ³
		X		X

¹ Payments used for any expenses indicated in this column are tax free only if the terms of the scholarship or fellowship do not prohibit the expense.

² If required of all students in the course.

³ Does not include amounts received under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.

1. Tax-Free Scholarships and Fellowships

A scholarship or fellowship is tax free only if:

- ☐ The recipient is a candidate for a degree at an eligible educational institution, and
- ☐ The recipient uses the scholarship or fellowship to pay qualified education expenses.

An eligible educational institution is one that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities. For purposes of tax-free scholarships and fellowships, these are expenses for:

- ❑ Tuition and fees required to enroll at or attend an eligible educational institution; and
- ❑ Course-related expenses, such as fees, books, supplies, and equipment that are required for the courses at the eligible educational institution. These items must be required of all students in the course of instruction.

However, in order for these to be qualified education expenses, the terms of the scholarship or fellowship cannot require that it be used for other purposes, such as room and board, or specify that it cannot be used for tuition or course-related expenses.

Qualified education expenses do not include the cost of:

- ❑ Room and board;
- ❑ Travel;
- ❑ Research;
- ❑ Clerical help; or
- ❑ Equipment and other expenses that are not required for enrollment in or attendance at an eligible educational institution.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance. Scholarship or fellowship amounts used to pay these costs are taxable.

2. Taxable Scholarships and Fellowships

If an individual's scholarship or fellowship does not meet the requirements described earlier, it is taxable. The following amounts received may be taxable.

- ❑ Amounts used to pay expenses that do not qualify;
- ❑ Payments for services; and
- ❑ Scholarship prizes.

A scholarship amount used to pay any expense that does not qualify is taxable, even if the expense is a fee that must be paid to the institution as a condition of enrollment or attendance.

Generally, an individual must include in income the part of any scholarship, fellowship, or tuition reduction that represents payment for past, present, or future teaching, research, or other services. This applies even if all candidates for a degree must perform the services to receive the degree.

An individual does not have to include in income the part of any scholarship or fellowship that represents payment for teaching, research, or other services if they receive the amount under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.

Example 1.

Kim received a scholarship of \$2,500. The scholarship was not received under either of the exceptions mentioned above. As a condition for receiving the scholarship, Kim must serve as a part-time teaching assistant. Of the \$2,500 scholarship, \$1,000 represents payment for teaching. The provider of Kim's scholarship gives her a Form W-2 showing \$1,000 as income. Kim used all the money for qualified education expenses. Assuming that all other conditions are met, \$1,500 of her scholarship is tax free. The \$1,000 Kim received for teaching is taxable.

Example 2.

Kim is a candidate for a degree at a medical school. She receives a scholarship (not under either of the exceptions mentioned above) for her medical education and training. The terms of the scholarship require Kim to perform future services. A substantial penalty applies if Kim does not comply. The entire amount of her grant is taxable as payment for services in the year it is received.

B. OTHER TYPES OF EDUCATIONAL ASSISTANCE

The following discussions deal with common types of educational assistance other than scholarships and fellowships.

1. Fulbright Grants

A Fulbright grant is generally treated as a scholarship or fellowship in figuring how much of the grant is tax-free.

2. Pell Grants and Other Title IV Need-Based Education Grants

These need-based grants are treated as scholarships for purposes of figuring their taxability. They are tax free to the extent used for qualified education expenses during the period for which a grant is awarded.

3. Payment to Service Academy Cadets

An appointment to a United States military academy is not a scholarship or fellowship. Payment an individual receives as a cadet or midshipman at an armed services academy is pay for personal services. This must be included in the recipient's income in most cases.

4. Veterans' Benefits

Payments an individual receives for education, training, or subsistence under any law administered by the Department of Veterans Affairs (VA) are tax-free.

5. Qualified Tuition Reduction

The term "qualified tuition reduction" means a tax-free reduction in tuition provided by an eligible educational institution. Whether a tuition reduction is a qualified tuition reduction, and therefore tax-free, depends on whether it is for education below or at the graduate level. The qualified tuition reduction must not represent payment for services.

Qualified tuition reductions for education below the graduate level (including primary and secondary school) are tax-free if provided to the following individuals who are treated as employees.

- ☐ A current employee of the eligible educational institution;
- ☐ A former employee who retired or left on disability;
- ☐ A widow or widower of an individual who died while an employee; or
- ☐ A widow or widower of a former employee who retired or left on disability.

Qualified tuition reductions apply to officers, owners, or highly compensated employees only if benefits are available to employees on a nondiscriminatory basis. This means that the tuition reduction benefits must be available on substantially the same basis to each member of a group of employees. The group must be defined under a reasonable classification set up by the employer. The classification must not discriminate in favor of owners, officers, or highly compensated employees.

Tuition reductions for graduate education are considered "qualified" and are tax-free if they are provided by an eligible educational institution to a graduate student who performs teaching or research activities for that institution. All other tuition reductions for graduate education are taxable.

CHAPTER 18 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. How many Coverdell Education Assistance Accounts can one individual have:
 - a) one
 - b) three
 - c) five
 - d) there is no limit
2. Money from a Coverdell ESA can be used to pay expenses associated with elementary, secondary and post-secondary education.
 - a) true
 - b) false
3. Under what circumstances are distributions from a Coverdell HSA tax-free:
 - a) whenever they are taken by the designated beneficiary
 - b) so long as the beneficiary is a full-time student at the time they are taken
 - c) to the extent the distributions do not exceed that individual's qualified educational expenses
 - d) to the extent the distributions do not exceed more than the beneficiary's normal living expenses
4. A Qualified Tuition Program:
 - a) is only available to families with incomes below \$200,000 per year
 - b) allows money to grow tax free
 - c) can be used by any family regardless of income
 - d) both b and c above
5. If a taxpayer withdraws funds from an individual retirement account to pay the qualified higher education expenses for the taxpayer's child or grandchild, the taxpayer will not owe either federal income tax or the 10 percent early withdrawal tax.
 - a) true
 - b) false

6. The Hope credit and lifetime learning credit can be claimed in the same year for the same student.
- a) true
 - b) false
7. Under what circumstances is money received in the form of a scholarship or fellowship tax-free:
- a) the recipient of the scholarship or fellowship is a student seeking a degree at an eligible institution
 - b) in all cases, regardless of how it is used
 - c) if the money is used to pay for qualifying educational expenses
 - d) both a and c above

CHAPTER 18 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. There is no hard cap.

B: Incorrect. While the annual amount that can be contributed is limited, the total number of accounts is not.

C: Incorrect. There is no such limit.

D: Correct. There is no limit to the number of accounts that can be established for a single beneficiary, although no more than \$2,000 can be contributed annually to all of the accounts combined.

(See page 18-1 of the course material.)

2. **A: True is correct.** Eligible postsecondary educational institutions include virtually all accredited, public, nonprofit, and proprietary postsecondary institutions. Eligible elementary and secondary schools include any public, private, or religious school that provides elementary or secondary education, as determined under state law.

B: False is incorrect. Unlike other educational benefits, both postsecondary and elementary or secondary schools are eligible institutions for purposes of Coverdell ESAs.

(See pages 18-2 to 18-3 of the course material.)

3. A: Incorrect. The monies must be used to pay for qualified educational expenses.

B: Incorrect. This is not sufficient to make all distributions tax-free.

C: Correct. Only in this case are all of the distributions tax-free. This calculation includes all of the support the beneficiary received for their education for the year in question.

D: Incorrect. The money is tax free only to the extent it covers certain qualified educational expenses.

(See pages 18-7 to 18-8 of the course material.)

4. A: Incorrect. The so-called 529 college savings plans are available to any family, regardless of income.

B: Incorrect. These programs allow families to put aside after-tax money and have it grow tax-free to pay for qualified education expenses. However, this is not the most correct answer.

C: Incorrect. Any family can create and contribute to these plans, regardless of income. However, this is not the best answer.

D: Correct. These are both attributes of so-called 529 college savings plans. There is, however, a lifetime cap on the amount of money that can be contributed to a plan. This amount differs from state to state.

(See pages 18-10 to 18-11 of the course material.)

5. A: True is incorrect. The taxpayer will owe federal income tax on the amount withdrawn, but will not be subject to the 10 percent early withdrawal tax that applies when amounts are withdrawn from an individual retirement account before the account holder reaches age 59½.

B: False is correct. The 10 percent early withdrawal tax does not apply to a distribution from an IRA to the extent that the amount of the distribution does not exceed the qualified higher education expenses for the taxpayer, the taxpayer's spouse, and the child or grandchild of the taxpayer or the taxpayer's spouse at an eligible educational institution. Federal income tax will be due on the amount withdrawn, unless from a Roth IRA.

(See page 18-13 of the course material.)

6. A: True is incorrect. Only one of the credits can be elected each year for each student.

B: False is correct. In order to claim the Hope education credit, the individual cannot also claim the lifetime learning credit in the same year. Also, the Hope credit cannot be claimed if the individual is married and files a separate return, or if their joint income is greater than \$116,000 (\$58,000 if single for 2008).

(See page 18-16 of the course material.)

7. A: Incorrect. The money must be received by a student seeking a degree. However, this is not the correct answer.

B: Incorrect. The recipient must meet certain conditions and the monies must be spent on certain qualifying expenses in order for the money to be considered tax-free.

C: Incorrect. The money must be spent to pay qualifying education expenses. However, there are other conditions required.

D: Correct. In order for money received in the form of a scholarship or fellowship to be non-taxable, both A and C must be true.

(See page 18-21 of the course material.)

Glossary

-- A --

A/B Trust: A type of Living Revocable Trust used by married couples. In this type of living trust, two trusts (trust A and trust B) are created at the time the first spouse dies. By dividing the couple's estate into two trusts at the first death, each spouse can pass the maximum amount of property allowed to avoid federal estate taxes.

Adjusted Gross Estate: Calculated by deducting estate settlement costs from the gross estate, also known as the taxable estate.

Administrator: The person appointed by the court to manage your estate when you die without leaving a will. Since they are court appointed, they are required to post a bond as security. They have the same duties as an executor. In some states, the position is called "personal representative."

Annuity: The right to receive a series of payments on a yearly basis or at other regular intervals for a certain or uncertain period. Generally the result of an annuity contract purchased by an individual.

Annual Exclusion: The amount of property the IRS allows a person to gift to another person during a calendar year before a gift tax is assessed and/ or a gift tax return must be filed. The amount is increased periodically.

At-risk rules: Rules that limit the amount of loss you may deduct to the amount you risk losing in the activity.

Attestation Clause: The clause in a will in which the witnesses certify that the will has been signed before them and describes how all parties signed the will.

-- B --

Basis: Basis is the amount of your investment in property for tax purposes. The basis of property you buy is usually the cost. Basis is used to figure gain or loss on the sale or disposition of investment property.

Back-end Load: A sales charge (also known as a "deferred sales charge") investors pay when they redeem (or sell) mutual fund shares, generally used by the fund to compensate brokers.

Beneficiary: An individual, institution, trustee or other entity designated in a will or trust to receive something of value.

Cash Basis Method: Method of determining when income must be reported and when expenses can be deducted. It is used by most individual taxpayers. Under the cash method, income is generally reported in the tax year money is received, and expenses are usually deducted in the tax year they are paid.

Charitable Lead Trust: An arrangement whereby the charity receives income from a trust for a period of years, and then the remainder is paid to non-charitable beneficiaries (generally either the donor or his or her heirs).

Charitable Remainder Trust: A trust used to make large donations of property or money to a charity so the person making the gift or donation can obtain a tax advantage. In a charitable remainder trust, the donor reserves the right to use the trust property during his life or some other specified time period, and when the agreed period is over, the property goes to the charity.

Closed-End Fund: A type of investment company that does not continuously offer its shares for sale but instead sells a fixed number of shares at one time (in the initial public offering) which then typically trade on a secondary market, such as the New York Stock Exchange or the Nasdaq Stock Market. Legally known as a "closed-end company."

Codicil: Technically a written addition or amendment to a will. Must be executed according to all of the formalities that govern a will itself to be valid.

Community Property: In the 10 states which are community property states, it is the property – real and personal – that is co-owned by each spouse. The law in these states presumes that property acquired during marriage is community property and limits the right of one spouse to dispose of such property either during life or upon death.

Contingent Beneficiary: Beneficiary of a trust or will who is entitled to receive certain property only if the primary beneficiary dies or otherwise is rendered unable to take the property.

Corporation: A legal entity that has rights usually only reserved for individuals. The primary advantage of a corporation is that it provides its shareholders with a right to participate in the profits without any personal liability.

Corpus of a Trust: Literally "the body" of the trust. Used to refer to the money or property placed in a trust. Distinguished from the income produced by the trust.

Crummey Trust: An irrevocable trust in which a beneficiary possesses a right to withdraw some or all of the property contributed for a period of time (usually 30 days), after which time the power lapses and the property is governed by the terms of the trust document; the beneficiary's right to withdraw is considered a gift of a present interest for gift tax purposes, thereby qualifying contributions for the gift tax annual exclusion; irrevocable life insurance trusts are usually Crummey trusts.

-- D --

Death Tax: Also known as estate tax, levied on a decedent's estate.

Decedent: An individual who has died.

Direct Skip: An outright generation-skipping transfer, either by gift or at death, to a recipient, known as a "skip person," who is two or more generation levels below the transferor. This type of property transfer prompts the generation-skipping transfer tax.

Dividend: A distribution of money or other property made by a corporation to its shareholders out of its earnings and profits.

Domicile: The state of a person's principal residence. An individual's domicile determines which state law applies to their estate. Each person can have only one domicile. Generally determined based on where the individual intended to make their permanent home.

Donee: One who receives a gift.

Donor: An individual who makes a gift. Also referred to as trustor, grantor or settlor in certain circumstances.

-- E --

Estate: The assets owned by a decedent at the time of his or her death are referred to as the estate.

Estate Planning: The process by which an individual determines how to divide his or her assets upon death or during their lifetime in anticipation of death.

Estate Taxes: Taxes imposed on the "privilege" of transferring property by reason of death. Estate tax is most commonly used in reference to the tax imposed by the Federal Government rather than the state government. Estate taxes are intended to raise revenue for the government and break up a family's wealth, so that the nation's wealth does not concentrate in the hands of a few families.

Exchange Fee: A fee that some mutual funds impose on shareholders if they exchange (transfer) to another fund within the same fund group.

Exchange-Traded Funds: A type of an investment company (either an open-end company or UIT) whose objective is to achieve the same return as a particular market index. ETFs differ from traditional open-end companies and UITs, because, pursuant to SEC exemptive orders, shares issued by ETFs trade on a secondary market and are only redeemable from the fund itself in very large blocks (blocks of 50,000 shares for example).

Executor/ Executrix: The person (male/female) named in a will to manage a decedent's estate. The more modern term is a "personal representative," which removes any reference to the sex of the person.

-- F --

Fair Market Value: The price at which an item can be sold at the present time between two unrelated people, neither under compulsion to buy or sell.

Fiduciary: A person with the legal duty to act primarily for another's benefit in a position of trust, good faith, candor and responsibility.

Fiduciary Duty: The duty of a fiduciary to act in a position of trust, good faith, candor and responsibility, on behalf of another. The duty is one of the best defined responsibilities under the law and is very strictly enforced by the courts.

Front-end Load: An upfront sales charge investors pay when they purchase mutual fund shares, generally used by the fund to compensate brokers. A front-end load reduces the amount available to purchase fund shares.

Future Interest: An ownership interest in property in which unlimited possession or enjoyment of property is delayed until some future time.

-- G --

General Partnership: A partnership that has only general partners and no limited partners. Each partner is liable for all partnership debts and there is no limited liability.

Generation Skipping Transfer (GST): A transfer of property, usually in trust, that is designed to provide benefits for beneficiaries who are two or more generations younger than the generation of the grantor.

Generation-Skipping Transfer ("GST") Tax: A separate 55% flat rate federal transfer tax in addition to the gift and estate taxes imposed on transfers to persons two or more generations below the transferor; each transferor has \$1,000,000 of inflation-indexed exemption from the GST tax.

Generation Skipping Trust: Any trust having beneficiaries who belong to two or more generations younger than the grantor.

Gift: Literally a gratuitous transfer of something of value from the owner to another person. To be a valid gift there must be intent, actual transfer to the donee or recipient of the gift and acceptance.

Gift Taxes: Taxes levied by the Federal Government on gifts. Gift taxes and estate taxes have been "merged" into a single tax called the "unified tax."

Grantor: The person who establishes a trust and transfers assets into it. Other terms for the "grantor" include "trustor" and "settlor."

Gross Estate: The total value of all property owned by a decedent at the time of his or her death.

-- H --

Hedge Fund: A special type of investment fund with fewer restrictions on the types of investments it can make. Of note is a hedge fund's ability to sell short. In exchange for the ability to use more aggressive strategies, hedge funds are more exclusive, i.e., fewer people, usually only the wealthy, are allowed to invest in hedge funds.

Heirs: Those persons who are entitled under the statutes of intestate succession to the property of a decedent. Also used to refer generally to beneficiaries of a will. Also known as "next of kin."

-- I --

Index Fund: Describes a type of mutual fund or Unit Investment Trust (UIT) whose investment objective typically is to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, the Russell 2000 Index, or the Wilshire 5000 Total Market Index.

Inherit: To receive property from a deceased person.

Insurance Trust: An irrevocable trust used to hold insurance and pass it on to your heirs without any estate taxes on the death benefits of the policy.

Inter Vivos: Literally means during life. Refers to transactions, such as gifts, made during a person's lifetime.

Inter Vivos Trust: Legal name for a living trust. The trust is set up by the grantor during his or her lifetime.

Intestate: A person who dies without having made and left a valid will.

Intestate Succession: The distribution of property to heirs according to the statutes of the state of residency upon the death of a person who owned the property but did not leave a valid will.

Irrevocable Trust: A trust that cannot be changed or terminated after it is established.

-- J --

Joint Tenancy: A form of property ownership in which two people co-own property with an automatic right of survivorship. If one of the owners dies, the surviving owner automatically receives the deceased's owner's interest. This allows real property to pass without going through probate.

-- K --

Keogh: A pension plan in the United States that allows a business to contribute a portion of profits into a tax-sheltered account.

-- L --

Limited Liability Company (LLC): An entity formed under state law that has the legal protection of owners similar to a corporation and the tax status of a partnership.

Limited Partner: A partner in a limited partnership not involved in the active management of the enterprise.

Limited Partnership: One consisting of at least one general partner and at least one limited partner. Must be formed in accordance with applicable state law.

Living Trust: A written legal document into which an individual places all of their property, with instructions for its management and distribution upon their disability or death.

-- M --

Management Fee: Fee paid out of mutual fund assets to the fund's investment adviser or its affiliates for managing the fund's portfolio, any other management fee payable to the fund's investment adviser or its affiliates, and any administrative fee payable to the investment adviser that are not included in the "Other Expenses" category.

Marked to market rule: The treatment of each section 1256 contract held by a taxpayer at the close of the year as if it were sold for its fair market value on the last business day of the year.

Marital Deduction: The tax law that allows a person to give an unlimited value of property as a gift, or leave an estate of unlimited value to his or her spouse without a gift or estate tax being assessed.

Medicare: A nationwide, federally administered health insurance program to cover the cost of hospitalization, medical care, and some related services for most people over age 65, and other selected groups.

Member: The term used to describe the owner of an interest in a limited liability company.

Member-Managed Company: A limited liability company that is managed by its owners. Unless specified otherwise in the articles of operation, a limited liability company is presumed to be managed by its members.

Merger: The process by which one business entity combines with another business entity.

Mutual Fund: The common name for an open-end investment company. Like other types of investment companies, mutual funds pool money from many investors and invest the money in stocks, bonds, short-term money-market instruments, or other securities. Mutual funds issue redeemable shares that investors purchase directly from the fund (or through a broker for the fund) instead of purchasing from investors on a secondary market.

-- N --

NAV (Net Asset Value): The value of a mutual fund's assets minus its liabilities. SEC rules require funds to calculate the NAV at least once daily. To calculate the NAV per share, simply subtract the fund's liabilities from its assets and then divide the result by the number of shares outstanding.

No-load Fund: A fund that does not charge any type of sales load. But not every type of shareholder fee is a "sales load," and a no-load fund may charge fees that are not sales loads. No-load funds also charge operating expenses.

-- O --

Open-End Company: The legal name for a mutual fund. An open-end company is a type of investment company.

-- P --

Partnership: A type of unincorporated business organization in which multiple individuals, called general partners, manage the business and are equally liable for its debts.

Passive activity: An activity involving the conduct of a trade or business in which you do not materially participate and any rental activity. However, the rental of real estate is not a passive activity if both of the following are true: (1) More than one-half of the personal services you perform during the year in all trades or businesses are performed in real property trades or businesses in which you materially participate; and (2) You perform more than 750 hours of services during the year in real property trades or businesses in which you materially participate.

Pay on Death (POD): Designation is the naming of a beneficiary to receive an account balance on a party's death.

Pour Over Trust: One which exists separately and independently of the will and is designated to serve as a custodian of property which it receives from the will.

Prospectus: Describes the mutual fund to prospective investors. Every mutual fund has a prospectus. The prospectus contains information about the mutual fund's costs, investment objectives, risks, and performance. You can get a prospectus from the mutual fund company (through its website or by phone or mail).

-- Q --

Qualified Terminable Interest Property ("QTIP"): An irrevocable trust for the benefit of the grantor's spouse which qualifies for the gift and/or estate tax marital deduction; must provide that spouse receives all of the trust accounting income at least as often as annually for life (e.g., cannot provide for reduction or cessation of income interest in the event of spouse's remarriage) and that no other person has any interest in the trust while the spouse is alive; principal benefit is that the grantor can control the disposition of the trust property at the spouse's death and still obtain the gift and/or estate tax marital deduction.

-- R --

Revocable: A trust in which the trustor (maker of the trust) has, by the terms of the trust agreement, reserved the power to alter, amend or terminate the trust and to receive the property back from the trustee.

Revocable Living Trust: A living trust or inter vivos trust that can be amended and revoked, usually by the person who established the trust. This trust may become irrevocable and unamendable when the only person who can amend or revoke the trust dies or becomes incompetent.

Revocable Trust: A trust which can be amended or revoked by the person(s) who established the trust.

-- S --

S Corporation: A special type of corporation in which shareholders receive the benefits of pass-through taxation generally available to partnerships while still maintaining limited liability. A number of requirements limit the type of entities eligible for this type of federal tax treatment.

Sales Charge (or "Load"): The amount that investors pay when they purchase (front-end load) or redeem (back-end load) shares in a mutual fund, similar to a commission. The SEC's rules do not limit the size of sales load a fund may charge, but the NASD's rules state that mutual fund sales loads cannot exceed 8.5% and must be even lower depending on other fees and charges assessed.

Separate Property: In community property states, all property which is not held commonly by a married couple is considered separate property. In general, it is property owned by one spouse in which the other spouse does not own an interest.

Settlor: A person who establishes a trust. The term settlor is used interchangeably with the terms "trustor" and "grantor."

Short Sale: The sale of shares of a security that the seller does not own. Such sales are made in anticipation of a decline in the price of the security to enable the seller to cover the sale with a purchase at a later date, at a lower price, and thus at a profit.

Sole Proprietorship: A business owned and operated by one person. The business has no legal existence separate from that of the owner.

Spendthrift: An individual who cannot handle money wisely and spends it wastefully.

Spendthrift Trust: One designed to provide for the needs of a spendthrift while protecting the corpus of the trust.

Split Gift: Each spouse is entitled to give any individual \$12,000 in a calendar year without tax consequences. If a married couple tries to give more than \$12,000 to an individual, they must file a gift tax form declaring that the gift is split between them.

Spouse: Legal term for a married person, either a husband or wife.

Surviving Spouse: The husband or wife that lives after the death of his or her spouse.

-- T --

Taxable Estate: The portion of an estate that is subject to federal estate taxes or state death taxes. Technically, all of an estate is subject to federal estate taxes, but because of the unified credit, only estates with a value over the exemption equivalent amount actually have to pay any estate taxes.

Term Life Insurance: Type of life insurance that provides temporary protection for a specified number of years.

Testamentary Trust: A trust, set up in a will, which does not become effective until the death of the testator.

Trust: A legal document by which one person, called the trustor, donor, grantor or settlor, places property in the title of the trust for the benefit of himself or another. Normally involves trustor, trustee, who is charged with managing the trust, and beneficiary, in whose behalf the trust is established.

Trustee: The person or institution that manages trust property under the terms of the trust.

Trustor: A person who establishes a trust. The term trustor is used interchangeably with the "settlor" and "grantor" or "donor."

-- U --

Unified Credit: A tax credit is given to each person by the IRS to be used during his or her life or after his or her death. The tax credit equals the amount of tax (gift or estate) which is assessed on the exemption equivalent value of property. It is considered the "unified" credit because it applies to both gift taxes and estate taxes.

Uniform Gifts (Transfers) To Minors Act (UGMA or UTMA): A method to hold property for the benefit of a minor, which is similar to a trust but the rules are governed by state law.

Unit Investment Trust (UIT): A type of investment company that typically makes a one-time "public offering" of only a specific, fixed number of units. A UIT will terminate and dissolve on a date established when the UIT is created (although some may terminate more than fifty years after they are created). UITs do not actively trade their investment portfolios.

Universal Life Insurance: Life insurance which combines the low-cost protection of term insurance with a savings component that is invested in a tax-deferred account, the cash value of which may be available for a loan to the policy holder.

-- W --

Warrant: A certificate issued by a company giving the holder the right to purchase securities at a stipulated price within specific time limits or with no expiration date (perpetual warrant). A warrant is sometimes offered by a company as an inducement to buy.

Wash Sale: The purchase and sale of a security either simultaneously or within a short period of time, often in order to recognize a tax loss without altering one's position.

Whole Life Insurance: A contract with both insurance and investment components.

Widows Allowance: The amount allowed by court order to be paid a decedent's widow and family from estate assets under administration.

- Y -

Yield: The annual return on an investment, expressed as a percentage.

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