FRANZEN & FRANZEN, LLP
CERTIFIED PUBLIC ACCOUNTANTS

July 23, 2012 – 2012 Second Quarter Federal Tax Developments

During the second quarter of 2012, there were many important federal tax developments. The following highlights some of the more important developments for you. As always, please give our office a call or email if you have any questions.

Health care legislation

In a 5-4 decision, the U.S. Supreme Court upheld the Patient Protection and Affordable Care Act (PPACA) and its companion law, the Health Care and Education Reconciliation Act (HCERA) on June 28, 2012 (National Federation of Independent Business et al. v. Sebelius). Chief Justice John Roberts, writing for the majority, held that the law's individual mandate is a valid exercise of Congress' taxing power. Four justices dissented and would have overturned the law.

Since 2010, the IRS has issued extensive guidance on the tax provisions in the health care legislation. Many of the tax provisions were effective in 2010, 2011 and 2012; but others are scheduled to take effect after 2012 and in subsequent years. These include an additional 0.9 percent Medicare tax for higher income individuals (tax years beginning after December 31, 2012), a Medicare tax of 3.8 percent on investment income for higher income individuals, trusts and estates (tax years beginning after December 31, 2012), and a higher threshold to claim an itemized deduction for unreimbursed medical expenses (tax years beginning after December 31, 2012 with a temporary waiver for individuals age 65 and older). Our office will keep you posted of developments.

Foreign accounts

The IRS announced in June streamlined procedures for U.S. citizens who are nonresidents, including dual citizens, who have failed to file U.S. income tax and information returns, such as Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR). The IRS also reported it has collected more than $5 billion from its 2009 and 2011 offshore voluntary disclosure initiatives (OVDI). The IRS reopened the 2011 OVDI in January 2012 but with less generous terms.

Corporations

In June, the IRS issued new temporary and proposed regulations on corporate inversions. The regulations remove the facts and circumstances test from regulations issued in 2009 and replace it with a bright-line rule describing the threshold of activities required for an expanded affiliated group (EAG) to have substantial business activities in the relevant foreign country. The regulations apply to transactions completed on or after June 7, 2012, the IRS explained.

Partnerships

The IRS unveiled in June a safe harbor under which it will not challenge a determination by a publicly traded partnership that income from discharge of indebtedness (cancellation of debt "COD" income) is qualifying income (passive-type income) under Code Sec. 7704(d). To benefit from the safe harbor, the COD income must result from debt incurred in activities that produce qualifying income.

Mortgage interest deduction

In May, the U.S. Tax Court found that a taxpayer who filed as married filing separately was limited to a deduction for interest paid on $500,000 of home acquisition indebtedness plus interest paid on $50,000 of home equity indebtedness (Bronstein, 138 TC No. 21). The court found that the plain language of the statute mandated this result, which is half the $1 million/$100,000 limit imposed on other taxpayers.

Deferred compensation

The IRS issued proposed regulations intended to tighten the definition of substantial risk of forfeiture (SRF) that applies to compensatory transfers of property in connection with the performance of services under Code Sec. 83 in June. As a result, fewer restrictions would qualify as an SRF.

Statute of limitations

On April 25, 2012, the U.S. Supreme Court resolved a split among the circuit courts of appeal by concluding that an overstatement of basis does not result in an omission of income for statute of limitations (SOL) purposes (Home Concrete & Supply, LLC). As a result the IRS has three years, rather than six years, to act against taxpayers who overstate basis except where fraud can be proved. The issue has arisen in a number of tax shelter cases where a taxpayer overstates basis in a partnership interest, resulting in an understatement of income.

Income

In April, a taxpayer successfully persuaded the Tax Court that her documentary film work was for-profit and not a hobby (Storey, TC Memo. 2012-115). The IRS had determined that the taxpayer, who had a full-time job as an attorney, had engaged in filmmaking without the intent to make a profit. The Tax Court found that the taxpayer had become skilled in filmmaking by attending classes, spent many hours outside of her full-time job on filmmaking and concluded that the taxpayer had a for-profit motive.

Estate tax

The IRS issued temporary and proposed regulations in June on temporary portability election for qualified estates. The portability election generally allows the estate of a deceased spouse dying after December 31, 2010 and before January 1, 2013 to transfer the decedent's unused estate tax exclusion amount, if any, to the surviving spouse.

Local lodging expenses

In May, the IRS issued proposed reliance regulations outlining when an employee may treat local lodging expenses as working condition fringe benefits or accountable plan reimbursements; and when employers may treat qualified expenditures as deductible business expenses. The proposed regulations also provide a safe harbor for an employee to deduct local lodging expenses if certain requirements are satisfied.

Deposit interest

The IRS issued final regulations in April requiring U.S. banks and other financial institutions to report interest on deposits paid to a nonresident alien (NRA). The requirement applies to residents of any country having a tax information exchange agreement (TIEA) with the U.S. The reporting requirement applies to interest payments made on or after January 1, 2013, the IRS explained.

Health savings accounts

The IRS announced in May inflation-adjusted amounts for health savings accounts (HSAs) in 2013. For 2013, the annual contribution limit for an individual with self-only coverage under a high deductible health plan (HDHP) is $3,250 compared to $3,100 for 2012. For 2013, the annual contribution limit for an individual with family coverage under a HDHP is $6,450, compared to $6,240 for 2012. A HDHP is defined as a health plan with an annual deductible that is not less than $1,250 for self-only coverage and $2,500 for family coverage for 2013.

Fresh start initiative

The IRS announced in May an expansion of its Fresh Start initiative, designed to help taxpayers struggling financially. The IRS provided more flexible terms to its offer in compromise (OIC) program. The IRS also instructed its examiners on taxpayers' ability to pay when student loans or state/local taxes are outstanding.

Economic substance

The Health Care and Education Reconciliation Act (HCERA) codified the economic substance doctrine. In April, IRS Chief Counsel released instructions to its personnel on when they may raise the codified economic substance doctrine.

Telephone tax refunds

In April, the IRS reminded taxpayers of the July 27, 2012 deadline to request refunds of federal excise taxes paid on long-distance telephone communications billed after February 23, 2003 and before August 1, 2006. In 2006, the IRS had announced that would stop collecting the three percent excise tax on long-distance telephone communications. Individuals who filed a 2006 return but who did not request a telephone excise tax refund should file an amended return or Form 1040-EZT (if not required to file a 2006 return).

Bankruptcy

The Supreme Court held in May that tax on a bankrupt debtor's post-petition farm sale was not dischargeable in bankruptcy (Hall). The Supreme Court found that federal income tax liability resulting from a debtor farmer's post-petition farm sale was not "incurred by the estate" under Bankruptcy Code Sec. 503(b).

IRS administration

In April, IRS Commissioner Douglas Shulman announced that he will step down at the end of his five-year term in September 2012. Shulman has overseen such high-profile programs as the offshore voluntary disclosure initiative (OVDI), the return preparer oversight initiative and modernization of the agency’s operating systems.

If you have any questions about these or any federal tax developments, please contact our office.