Tax News and Industry Updates

2015
Volume 3, Issue 3

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Tax-Exempt Status Revoked

Cross References

- *Educational Assistance Foundation,* U.S. District Court for the District of D.C, July 6, 2015

Under IRC section 501(a) and section 501(c)(3), an organization is exempt from federal income taxation if it meets the following three requirements:

- It is organized and operated exclusively for an exempt purpose,
- Its net earnings do not go to benefit of any private shareholder or individual, and
- Its activities do not attempt to influence legislation.

If the organization is a public charity, donations to the organization are deductible as charitable contributions. [IRC §170(c)]

Julius Schaller died in December 2003. The executors of his estate incorporated the Educational Assistance Foundation for the Descendants of Hungarian Immigrants in the Performing Arts, Inc., for the purpose of providing financial assistance to college students who descend from an immigrant from the Hungarian area of Eastern Europe and are involved in the performing arts.

In June 2004, the Foundation applied to the IRS for tax-exempt status, and the IRS determined that the Foundation qualified as an exempt organization under IRC section 501(c)(3). After the IRS granted the Foundation tax-exempt status, the Schaller estate transferred $2,595,847 to the Foundation and claimed a corresponding federal tax deduction that reduced Schaller's net estate taxes and generation-skipping transfer taxes to zero. This sole transfer constituted the Foundation's only donation and source of funding.

In 2004 and 2005, the Foundation awarded financial scholarships to several scholarship recipients who were direct descendants of Julius Schaller. The IRS conducted an audit of the Foundation's activities and concluded that the Foundation did not qualify for tax-exempt status because it was organized and operated exclusively for the benefit of Julius Schaller's Will. The IRS determined that its revocation would apply retroactive to the date of the Foundation's inception because it omitted and misstated material facts in its application for exemption.

Regulation section 1.501(c)(3)-1(d)(1)(ii) says an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. It is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly by such private interests.

The Foundation argued that it was expressly organized to potentially benefit all Hungarian immigrant descendants and that there is simply no basis to apply the private benefit doctrine here because the four scholarship recipients met the criteria to receive scholarship awards from the Foundation. The Foundation also said that it should have been allotted five years to operate and develop before being subjected to an audit by the IRS. An audit after only two years of tax-exempt status was premature and did not afford it an appropriate amount of time to begin operations.

The court rejected these arguments. The Foundation was operated in a manner that benefitted a single family. Every educational scholarship it issued during its existence was to a descendant of Julius Schaller. Charitable contributions to the Foundation originated from one source; the estate of Julius Schaller. The executors of the Schaller Estate were all relatives of Julius Schaller and maintained control over the Foundation's operations as the members of its Board of Directors. And other court cases show that prohibited inurement may still occur even if a charitable beneficiary is a member of a larger class that would otherwise qualify the organization for tax-exempt status.

The court said the Foundation failed to offer any authority suggesting that there is a 5-year period used to determine tax-exempt status. The government is not required to adopt a wait and see approach. The Foundation's decision to award its scholarships exclusively to members of one family was an improper inurement that precludes the Foundation from having tax-exempt status, and the court concluded that the IRS properly revoked the Foundation's tax-exempt status.

Mortgage Debt Limits Apply on a Per Taxpayer Basis

Cross References

- IRC §163
- *Bruce H. Voss and C.J. Sophy,* 9th Cir., August 7, 2015

The 9th Circuit Court of Appeals has ruled that the mortgage interest deduction debt limits apply to unmarried co-owners on a per-taxpayer basis, not on a per-residence basis.

IRC section 163 allows taxpayers to deduct interest paid on a mortgage and/or a home equity line of credit for a principal residence and a second home. The interest deduction is limited to the first $1 million of acquisition debt and the first $100,000 of home-equity debt. When the taxpayer's home indebtedness exceeds these limits, the taxpayer is allowed to deduct a portion of the interest determined by the ratio of the statutory debt limit divided by the actual debt.

The taxpayers in this case were two unmarried co-owners of two homes as joint tenants. They were registered as domestic partners in the state of California. The combined debt on the two homes exceeded $1.1 million. Each co-owner filed separate federal returns as single taxpayers, and each applied his own $1.1 million debt limit when figuring his mortgage interest deduction. The IRS audited their returns and calculated each taxpayer's mortgage interest deduction by applying the $1.1 million debt limit on a per-residence basis rather than on a per-taxpayer basis. The Tax Court ruled in favor of the IRS.

The taxpayers appealed to the Ninth Circuit Court of Appeals. Before the court was the question of whether the $1.1 million debt limits apply per taxpayer or per residence. If they apply per taxpayer, then the two unmarried co-owners together can deduct interest on up to $2.2 million of acquisition and home equity debt. If the debt limit provisions apply per residence, as the Tax Court and IRS believe, then the $1 million and $100,000 debt limits must be divided up in some way between the two single taxpayers.

The Court of Appeals noted that Congress did not make it clear whether the debt limits apply on a per-taxpayer or a per-residence basis. However, the court noted that they are not left without some textual guidance. Both debt limit provisions contain a parenthetical that speaks to one common situation of co-ownership. The parentheticals provide half-sized debt limits in the case of a married individual filing a separate return. Congress' use of the phrase "in the case of" is important for two reasons:

- It suggests that the parentheticals contain an exception to the general debt limit set out in the main clause and not as an illustration of how that general debt limit should be applied.
- It also suggests a certain parallelism between the parenthetical and the main clause of each provision. Other than the different debt limit amounts for married filing separate, we can expect that in all respects the case of a married filing separate return should be treated like any other situation.

These parentheticals offer at least three useful insights:

- The parentheticals clearly speak in per-taxpayer terms. The limit on acquisition indebtedness is $500,000 in the case of a married individual filing a separate return, and the limit on home equity indebtedness is $50,000 in the case of a separate return by a married individual.
- The parentheticals give each separately filing spouse a separate debt limit of $550,000 so that, together, the two spouses are effectively entitled to a $1.1 million debt limit.
- The very inclusion of the parentheticals suggests that the debt limits apply per taxpayer.

The court noted that the mortgage debt limit is not the only provision that does this. Congress has on a number of occasions provided half-sized deductions, credits, or limits for separately filing spouses. The purpose of these provisions is obvious. In each provision, each taxpayer gets some tax benefit, a credit, an exclusion up to some limit, allowable losses up to some limit, or, in this case, a deduction on interest on home debt up to some limit. Congress, knowing that joint filers are treated as a single taxpayer and that separate filers are treated as two separate taxpayers, wants to ensure that the separately filing spouses do not get double the benefit that jointly filing couples get. And so, in each of these provisions, Congress provides that separately filing spouses each get half the benefit. It is to ensure that the separately filing spouses don't get double the credit, double the exclusion, double the losses, or double the debt limit that the jointly filing couple gets.

The court also noted that IRC section 163(h) repeatedly makes reference to a single taxable year. Residences do not have taxable years. Only taxpayers have taxable years. IRC section 163(h) reference to a single taxable year implies that the debt limits apply per taxpayer.

The court also noted the term "qualified residence" as referenced in IRC section 163(h). The term clearly focuses on the taxpayer. The term includes the principal residence of the taxpayer and one other residence of the taxpayer that is used by the taxpayer as a residence and is selected by the taxpayer. The term also specifies that the taxpayer may select the secondary residence for the taxable year, suggesting that a taxpayer who owns multiple secondary residences can change his or her one other residence from one tax year to the next. As the term "qualified residence" is defined, it is entirely possible that two residence co-owners might each have a different qualified residence. For example, two individuals might each have a separate primary residence but go in together on a vacation home in Maui. For such co-owners, filing tax returns under the IRS and Tax Court's per-residence approach would be like running a three-legged race. The co-owners are tied together for one home but not the other. This would mean that the two, three, or four co-owners would have to coordinate their tax returns to ensure that the aggregate amount of acquisition debt for each taxpayer's qualified residence does not exceed the debt limit. It would also mean that one co-owner's deduction might depend on the size of another co-owner's mortgage on a home in which the first co-owner has no interest. Under the per-taxpayer approach, by contrast, determining the amount of acquisition debt is free of such difficulties. Each taxpayer can calculate the deduction with reference to his or her respective two residences.

The IRS also argued that applying the debt limit provisions on a per-taxpayer basis creates a marriage penalty. Married filing joint individuals have a combined $1.1 million debt limit, while two unmarried co-owners have a combined $2.2 million debt limit. The Court of Appeals agreed, but so what. There are other provisions in the tax code that create a marriage penalty, and sometimes Congress addresses these. In this particular case, Congress did not provide specific language to address the marriage penalty.

Based upon the above analysis, the Court of Appeals ruled that the debt limits apply on a per-taxpayer basis, not on a per-residence basis.

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Identity Protection Services Are Not Taxable

Cross References

- IRS Announcement 2015-22

Consumers, employees, and taxpayers in general can be the victim of identity theft when an organization's recordkeeping system has been "hacked" or otherwise exposed to identity thieves. In response to such data breaches, organizations often provide credit reporting and monitoring services, identity theft insurance policies, identity restoration services, or other similar services to affected customers, employees, or other individuals whose personal information may have been compromised as a result of the data breach. These identity protection services are intended to prevent and mitigate losses due to identity theft resulting from the data breach.

The IRS has ruled that the value of such identity protection services is not taxable. Consumers and other taxpayers receiving this type of service do not include the value in gross income, and employers providing these services to employees do not include the value in the employee's gross income as wages. Additionally, the value is not reported on an information return, such as a W-2 or 1099-MISC.

This rule does not apply to cash received in lieu of identity protection services, or to identity protection services received for reasons other than as a result of a data breach, such as identity protection services received in connection with an employee's compensation benefit package.

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Trade Preferences Extension Act of 2015

Cross References

• Public Law 114-27

On June 29, 2015, the President signed into law H.R. 1295, the "Trade Preferences Extension Act of 2015." The law extends a number of trade agreements as well as trade adjustment assistance. Trade adjustment assistance refers to a group of programs that provide federal job-training and other assistance to workers, farmers, and communities that have been adversely impacted by foreign trade, including workers who have lost their jobs due to having their jobs moved overseas or as a result of increased imports. Included in the new law are a number of tax related provisions. This article covers those tax related provisions.

Education Tax Benefits

There are currently three education tax benefits that help qualified students pay for tuition, enrollment fees, course-related books, supplies, and certain equipment. The American Opportunity Credit (Hope Credit) provides a tax credit of up to $2,500 for undergraduate and graduate study expenses incurred within the first four years of post-secondary education. The Lifetime Learning Credit provides a tax credit of up to $2,000 for undergraduate, graduate study, or expenses for courses to acquire or improve job skills. The Tuition and Fees Deduction allows a deduction of up to $4,000 for undergraduate and graduate study expenses.

The educational institution is required to provide the student with an information return (Form 1098-T, *Tuition Statement)* which provides the student's name, address, and TIN, along with the amount of payments received by the institution and amounts billed by the institution for qualified tuition and related expenses. The information return may also provide other information such as any adjustments, reimbursements, or refunds of such expenses. Under prior law, enforcement of this information reporting requirement was limited to a penalty payable by the educational institution for failure to furnish this information.

New Law: Under the new law, a taxpayer cannot claim an education credit or the tuition and fees deduction unless the taxpayer receives the information statement (Form 1098-T, *Tuition Statement)* from the educational institution that furnishes the required information. This rule is effective for tax years beginning after June 29, 2015 (2016 tax year for calendar year taxpayers).

Penalty exception. For information statements required to be furnished after December 31, 2015, no penalty will apply solely by reason of failing to provide the TIN of an individual if the educational institution required to provide the information return makes a true and accurate certification that it has complied with standards promulgated by the IRS for obtaining such individual's TIN.

Child Tax Credit

Eligible taxpayers can claim a child tax credit of up to $1,000 per qualifying child. If the taxpayer cannot benefit from the full $1,000 per child credit, a refundable additional child tax credit may apply that is basically designed to refund a portion of the taxpayer's FICA and Medicare tax paid.

New Law: Effective for tax years beginning in 2015, the refundable portion of the child tax credit is not allowed for any taxpayer for any taxable year if the taxpayer elects to exclude income under the foreign earned income exclusion rules.

Health Coverage Tax Credit

The Health Coverage Tax Credit (HCTC) under IRC section 35 expired for tax years after 2013, and was not included with the expiring provisions that were extended under the Tax Increase Prevention Act of 2014, signed into law in December of 2014. As a result, the HCTC was not available for 2014 during the tax filing season for 2014 returns.

In general, the HCTC was a refundable credit of 72.5% of qualified health insurance coverage payments made by qualified taxpayers. An individual qualified for this credit if he or she:

- Was an eligible trade adjustment assistance (TAA) recipient, alternative TAA recipient, reemployment TAA (RTAA) recipient, or Pension Benefit Guaranty Corporation (PBGC) pension payee. Also eligible were qualified family members of an individual who fell under one of these categories when he or she passed away or with whom a divorce was finalized.
- Was covered by a qualified health insurance plan for which the individual paid, either a portion or all of the premiums, directly to the health plan.
- Was not claimed as a dependent on anyone else's tax return.
- Was not enrolled in Medicare Part A, B, or C, or if enrolled, the individual's family member(s) qualified for the Health Coverage Tax Credit.
- Was not enrolled in Medicaid or Children's Health Insurance Program (CHIP).
- Was not enrolled in the Federal Employees Health Benefits Program or eligible to receive benefits under the U.S. military health system (TRICARE).
- Was not imprisoned under federal, state, or local authority.

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- Did not have an employer that paid more than 50% of the cost of his or her health coverage.
- Did not receive a 65% COBRA premium reduction from a former employer or COBRA administrator.

New Law: The new law retroactively reinstates the HCTC for 2014, and all future years for months beginning before January 1, 2020. The HCTC is an election, meaning eligible taxpayers are not required to have this tax provision apply.

If the taxpayer elects to have the HCTC provision apply, the months for which the HCTC applies are not treated as coverage months for purposes of the Premium Tax Credit (PTC). Thus, the taxpayer is not eligible for a double benefit (both the HCTC and PTC) in the same month. The new law contains other coordination provisions in cases where the taxpayer already received an advance payment of the PTC.

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