2024 NATIONAL INCOME TAX WORKBOOK

CHAPTER 11: INDIVIDUAL TAX ISSUES: PART 2

Land Grant University Tax Education Foundation

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ISSUES TO BE ADDRESSED IN THIS CHAPTER

P. 395

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LEARNING OBJECTIVES

P. 395

- Understand when a taxpayer is eligible to contribute to an HSA
- Know when health savings account distributions are excluded from income
- Advise a client about section 529 education savings programs
- Recognize when a taxpayer can roll over a section 529 plan to a Roth IRA
- Understand when cancellation of debt is included in income
- Know the exceptions and exclusions to the recognition of cancellation-of-debt income
- Calculate the reduction in tax attributes when cancellation of debt is excluded from income

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ISSUE 1: HEALTH SAVINGS ACCOUNTS P. 397

An I.R.C. § 223 health savings account (HSA)
- tax-advantaged custodial account
- to pay or reimburse medical expenses not covered by health insurance

Contributions can be made until the deadline for filing the income tax return (without extensions).

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ISSUE 1: HEALTH SAVINGS ACCOUNTS P. 397

Subject to certain limits;
- individual contributions to an HSA are tax deductible
- employer contributions are excluded from an employee's income

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ISSUE 1: HEALTH SAVINGS ACCOUNTS P. 397

HSA contributions can grow tax-free.

Distributions are excluded from gross income if they are used for the account beneficiary's qualified medical expenses.

HSA accounts are portable.

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HSA ELIGIBILITY REQUIREMENTS P. 397

1. The taxpayer must be enrolled in a qualified high-deductible health plan (HDHP) as of the first day of the month.
2. Generally, the taxpayer cannot be covered under any health plan that is not an HDHP, or that plan covers any benefit that is covered by the HDHP.
3. The taxpayer cannot be enrolled in Medicare.
4. The taxpayer cannot be claimed as a dependent on someone else's tax return.

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HSA ELIGIBILITY REQUIREMENTS P. 397

Eligibility for an HSA is generally determined on the first day of each month.

Ex: enrolled in an HSA on the 25th of Oct, then the individual becomes eligible to contribute on Nov 1st.

Taxpayers who become eligible on the 1st day last month (Usually Dec 1st)

- Are eligible for the entire year
- Must remain eligible for all months of the following year

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HSA ELIGIBILITY REQUIREMENTS P. 397

If the taxpayer becomes ineligible during the 13 month-testing period,

- then contributions made during the ineligible period are included in gross income
- subject to a 10% additional tax

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HSA ELIGIBILITY REQUIREMENTS P. 397

Example 11.1 Last Month Rule

Practitioner Note: Prorated Contributions

Taxpayer expects to become ineligible during the 13 month period

- Divide the contribution limit by 12
- Contribute that amount for each month of eligibility

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QUALIFIED HDHP P. 398

An HDHP can be for an individual or for family coverage; it must meet requirements.

1. Minimum deductibles: $1,600 (self-only), $3,200 (family) for 2024, $1,650 and $3,300 for 2025, respectively
2. For 2024 maximum out-of-pocket is $8,050 (self-only), $16,100 (family)

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QUALIFIED HDHP P. 398

3. The plan can cover only preventative care and some telehealth services before the deductible is met
4. The plan's coverage cannot be restricted to limited benefits, e.g., vision or dental

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QUALIFIED HDHP- MINIMUM DEDUCTIBLE P. 398

The HDHP minimum deductible is inflation adjusted annually

The HDHP may cover preventative services without a deductible

There is a list of 6 common services provided

Screening services have an additional list of conditions.

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QUALIFIED HDHP- MINIMUM DEDUCTIBLE P. 398

HDHPs can cover telehealth and other remote services on a predeductible basis for plan years 2023 and 2024.

HDHPs may also provide benefits under anti-surprise billing laws with a $0 deductible.

Practitioner Note: Expiration of COVID-19 Relief for HDHPs

◦ As of July 24, 2023, HDHP may no longer provide COVID-19 testing without a deductible.

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QUALIFIED HDHP- OUT-OF-POCKET LIMITS P. 399

The out-of-pocket limits increases for inflation annually

Limits generally include the following share requirements for in-network services:

1. Deductibles
2. Coinsurance
3. Copayments

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QUALIFIED HDHP- OUT-OF-POCKET LIMITS

P. 399

- The following DO NOT count towards the limit
  1. Payments to out-of-network providers for services
- 2. Payments for noncovered services
- 3. Premiums for insurance coverage, including the HDHP plan

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DISQUALIFYING COVERAGE

P. 399

To be eligible to contribute to an HSA, a taxpayer may not, with limited exceptions, have coverage under a health plan other than the HSA-qualified HDHP

Common types of disqualifying coverage:

Flexible spending accounts (FSAs)

1. Standard health reimbursement arrangements (HRAs)
2. Coverage under a spouse's or parent's health plan
3. Medicare or TRICARE

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DISQUALIFYING COVERAGE

PP. 399-400

There are limited purpose plans which are allowable, a list of 6 is provided on pg 399.

Example 11.2

Madelyn Turner's employer provides self-only HSA-qualified HDHP coverage for her. Madelyn is also covered by her spouse's HRA. Madelyn is not eligible to contribute to an HSA because the HRA is disqualifying coverage

18

CONTRIBUTIONS

P. 400

A taxpayer may establish an HSA with a qualified trustee authorized by the IRS to hold individual retirement accounts (IRAs) or Archer medical savings accounts (MSAs).

Spouses who are each eligible must have their own HSAs. There are no joint HSAs.

Family members may make contributions on behalf of the eligible individual

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CONTRIBUTION LIMITS

P. 400

Either spouse has family HDHP coverage

- Both spouses treated has having family coverage
- The spouses share the $8,300 limit (or $10,300 if both ≥
- Spouses divide limit equally unless agree to different allocation.

Limits are reduced by tax-free contributions made by an employer.

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CONTRIBUTION LIMITS

P. 400

HSA Contribution Limits

	2024	2025
Self-only	$4,150	$4,300
Family	$8,300	$8,550
Catch-up contributions	$1,000	$1,000

Rev. Proc. 2023-23, 2023-22 I.R.B. 883; Rev. Proc. 2024-25, 2024-22 I.R.B.

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CONTRIBUTION LIMITS P. 400

Excess Contributions
- Generally, a 6% excise applies to an excess contribution unless
  - The excess contribution is withdrawn before the deadline, including extensions, and
  - Any income earned is withdrawn and included as "Other Income" on the tax return in the year received.

Observation: No Income Restrictions

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CONTRIBUTION LIMITS P. 401

Contributors
- An individual can contribute to his/her HSA
- Any other person can contribute to the employee's HSA
- Employers can contribute to the employee's HSA

The contribution limit must be observed regardless of who contributes to the HSA

23

POLLING QUESTION #1

HSAs allow for catch-up contributions.

True False

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QUALIFIED HSA FUNDING IRA DISTRIBUTION P. 401

I.R.C. 408(d)(9) provides that a taxpayer may make one life-time tax-free direct rollover from a traditional or ROTH IRA to an HSA.

The taxpayer must remain eligible for an HSA until the last day of the 12th month following such a distribution, if not, then the distribution is included in income and subject to a 10% early distribution penalty.

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QUALIFIED HSA FUNDING IRA DISTRIBUTION P. 401

If the taxpayer makes a qualified HSA funding distribution when he/she has self-only coverage, the taxpayer can make a second qualified HSA funding distribution in the same tax year if he/she changes to family HDHP coverage.

HSA funding distribution cannot exceed the difference between the family coverage limit and amount previously contributed.

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ROLLOVERS P. 401

A taxpayer can make one rollover contribution to an HSA from another HSA or an Archer MSA during any 1-year period.

Rollovers must be completed with in 60 days of receipt of the funds.

A trustee-to-trustee transfer is not considered to be a rollover and can be completed at any time.

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HSA DISTRIBUTIONS
P. 401

A tax-free distribution can be received to pay for qualified medical expenses for individuals covered under the HDHP plan.

Qualified medical expenses are included for persons who could have been a dependent but were excepted:

- Persons filing a joint return
- Persons having gross income of $5,050 or more (2024)
- The taxpayer, or spouse (MFJ), could be claimed as a dependent on another return.

Special rules apply to a child(ren) of parents who are divorced or separated, or who have lived apart for the last 6 months of the calendar year.

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QUALIFIED MEDICAL EXPENSES
PP. 401-402

Medical expenses that generally qualify under the Code as a medical deduction are qualified for HSA reimbursements, except for most insurance premiums.

Starting in 2020, qualified medical expenses were broadened to include: menstrual products, OTC medications, COVID-19 tests, and Personal Protective Equipment.

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QUALIFIED MEDICAL EXPENSES
P. 402

HSA-qualified HDHP premiums are not qualified medical expenses nor are Medicare supplemental policies.

Specific premiums are allowable:

- Qualified long-term care (subject to age limits)
- COBRA payments to continue coverage
- Premiums paid while collecting unemployment compensation
- Medicare premiums for those 65 or older

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QUALIFIED MEDICAL EXPENSES P. 402

Planning Pointer: Distribution Timing

No time limit to make HSA distributions.

Medical expenses incurred before the HSA was established do not qualify.

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QUALIFIED MEDICAL EXPENSES P. 402

Nonqualified expenses for which distributions are received are income and subject to a 20% additional tax

Exceptions to the 20% additional tax:

- Account beneficiary becomes disabled or dies
- Taxpayer is age 65 or older

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SPOUSES AND DEPENDENTS P. 403

Coverage Level	HSA Eligibility and Contribution Limit
Both spouses covered by family HDHP	Each spouse can contribute to HSA, and the maximum contribution is the family limit. Spouses divide contributions by agreement.
One spouse covered by family HDHP and one spouse covered by self-only HDHP	Each spouse can contribute to HSA, and the maximum contribution is the family limit. Spouses divide contributions by agreement.
Both spouses covered by self-only HDHPs	Each spouse can contribute to HSA, and the maximum contribution is the family limit.
One spouse covered by self-only HDHP, other spouse covered by non-HDHP insurance or Medicare	Only spouse with HDHP can contribute to HSA, and the maximum contribution is the self-only limit.
One spouse covered by self-only HDHP, but also by other spouse's non-HDHP family plan or HRA	Neither spouse can contribute to HSA.
Both spouses covered by family HDHP and one spouse also covered by Medicare	Only non-Medicare spouse can contribute to HSA, and the maximum contribution is the family limit.

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SPOUSES AND DEPENDENTS P. 403

Affordable Care Act, Pub. L. No. 114-148

Health insurance plans with dependent child coverage

1. Allows nondependent adult child under age 26 to remain on parents' health insurance plan

2. Covered by parents' HDHP can establish own HSA with family contribution limit.

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SPOUSES AND DEPENDENTS P. 403

Example 11.3 Adult Child under Age 26

- Alex, 24, graduated from college
- Parents have a family HDHP, each contributes $4,150
- Alex contributes $4,150 to his HSA
- Alex's aunt contributes $4,150 to Alex's HSA too
- Alex may deduct $8,300 on his tax return

Practitioner Note: Adult Child with Other Coverage

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TAXPAYERS AGE 65 AND OLDER P. 404

Taxpayer enrolls in Medicare:

- Ineligible to contribute to an HSA
- Ineligibility begins 1st month taxpayer enrolls in Medicare
- May continue to take tax-free distributions

Example 11.4 Medicare is Disqualifying Coverage

36

TAXPAYERS AGE 65 AND OLDER

P. 404

Can use HSA funds to pay for Medicare premiums.

Medicare supplemental policies are nonqualified distributions.

Nonqualified distributions are included in taxable income.

Nonqualified distributions are not subject to the 20% additional tax.

Example 11.5 Nonqualified Distribution

37

TAXPAYERS AGE 65 AND OLDER

P. 404

A taxpayer age 65 or older may delay enrolling in Medicare.

- Can continue to contribute to an HSA.
- Medicare coverage retroactive by 6 months or day individual turned 65, whichever is shorter.
- HSA contributions during retroactive period are disqualified.
- Subject to 6% additional tax on excess contributions.

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TAXPAYERS AGE 65 AND OLDER

P. 404

One spouse covered by Medicare and the other is not:

- Medicare enrollee is ineligible to contribute to the HSA.
- Non-Medicare spouse may contribute to HSA up to the family limit (if HDHP family plan).
- Medical expenses of both spouses covered by the HSA.

Example 11.6 Spouses and Medicare

39

DEATH OF HSA HOLDER

P. 405

An HSA account holder names a beneficiary:

- If the beneficiary is the spouse, the account is treated as the spouse's HSA.
- If the beneficiary is not the spouse, the account's value is included in the beneficiary's income and is not a continuing HSA.
- If the beneficiary is the decedent's estate, the value of the HSA is included as income on the decedent's final income tax return.

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TAX REPORTING

P. 405

The HSA contribution is treated as an adjustment to income.

HSA activity is reported on IRS Form 8889; a separate IRS Form 8889 is required for each HSA account.

Contributions are reported on Form 5498 by the HSA account trustee.

Distributions are reported on Form 1099-S .

20%, 10%, or 6% additional taxes are imposed depending upon circumstances.

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ISSUE 2: SECTION 529 PLANS

P. 406

529 qualified tuition plans provide a tax-advantaged method for taxpayers to save for education costs.

After December 31, 2023, taxpayers can make a tax-free rollover from a 529 plan to a Roth IRA.

529 plans may be offered by a qualified educational institution, state or agency of a state. All 50 states and District of Columbia offer some type of plan.

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TYPES OF PLANS P. 406

Most 529 plans are structured as savings plans with earnings being tax free. Subsequent distributions are tax free too if used for qualified expenses:
- Higher-education expenses
- After 2017, expenses for kindergarten through twelfth grade are allowed

Prepaid tuition plans are used to “lock in” the price of college at current tuition

Example 11.7 Prepaid Tuition Plan

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TYPES OF PLANS P. 406

The Private College 529 Plan is the only non-state sponsored plan giving access to almost 300 private colleges and universities.

Michigan offers a 529 plan (Not in the book)
- Allows a subtraction on the return for contributions
- Requires attending a Michigan college or university

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SECTION 529 SAVINGS PLAN REQUIREMENTS P. 407

529 plans have 6 requirements that must be met.
- See list of six items

Contributors
- Generally, are individuals: parents, grandparents, other relatives.
- Contributor does not need to be related to beneficiary.
- Individual can contribute to their own plan.

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POLLING QUESTION #2

A grandparent can contribute to a 529 plan.

True False

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SECTION 529 SAVINGS PLAN REQUIREMENTS P.407

Excess Contributions

- The plan provider must ensure that contributions do not exceed the estimated cost of education
- Maximum contribution = 5 years of postsecondary school at most expensive option
- plus costs of K-12 tuition
- up to $10,000 per year per child

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TAXATION OF SECTION 529 SAVINGS PLANS P. 407

Contributions limited to annual gift tax exclusion.

Income tax

- No AGI limitation, no deduction for contribution, some states allow a deduction.
- Contribution is not included in taxable income of the beneficiary.
- Qualified distributions not taxable.

Practitioner Note: Miscellaneous Itemized Deductions

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TAXATION OF SECTION 529 SAVINGS PLANS P. 407-408

Gift Tax
- Contribution is a completed gift ($18,000/yr),
- Special rule to allow up to 5 years for excess contributions
- Election on IRS Form 709
- Designation of new beneficiary may be a taxable gift.

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TAXATION OF SECTION 529 SAVINGS PLANS P. 408

Estate Tax
- No interest in a 529 plan is included in a contributor's or beneficiary's estate
  - Amounts distributed due to beneficiary's death are included in the beneficiary's estate
  - If the donor dies before the completion of the 5-year period, the donor's estate includes that which is allocable to periods after death

Planning Pointer-Successor Account Owner

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CHANGES IN BENEFICIARIES OR PROGRAMS P. 408

Rollover to another 529 plan
- Amounts can be rolled over to another plan for the same beneficiary.
- the 60-day rule applies. Rollovers are allowed only once per year.
- Can roll over contributions for a different beneficiary in the same family.
- A member of the family is listed as four relationships.

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CHANGES IN BENEFICIARIES OR PROGRAMS P. 408

Cross-Reference: ABLE Accounts

Practitioner Note: Education Savings Accounts Rollovers

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CHANGES IN BENEFICIARIES OR PROGRAMS P. 409

Recontributions
- A beneficiary receiving a refund of qualified higher-education expenses may recontribute these funds into a 529 for the same beneficiary.
- Not later than 60 days after the refund.

Practitioner Note: Transfers from a Custodial Account

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DISTRIBUTIONS P. 409

Qualified distributions for higher-education expenses are:
- Tuition, fees, books, supplies and equipment
- Special needs services
- Computer and peripheral equipment
- Room and board; for at least a half-time enrollee (6 hours on semester system)

Practitioner Note: Qualified Distribution for Student Loan Repayment

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DISTRIBUTIONS P. 410

Definition of an eligible educational institution:
- any post-secondary educational institution
- participates in student financial aid programs administered by US Dept. of Education.
- After December 31, 2017, also includes K-12
  - distribution limited to $10,000 per year per student

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DISTRIBUTIONS P. 410

Earnings not included in income if distribution ≤ beneficiary's QHEE

Earnings may be taxable if distributions > beneficiary's QHEE

Room and board expenses qualify as a 529 plan expense
- May be off campus or a parent's residence

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DISTRIBUTIONS P. 410

Coordination with Other Education Tax Benefits
- QHEE can only be used once
- Expenses disregarded in determining QHEE for 529 plans
  - Expenses paid by grants, scholarships, etc
  - Expenses used to claim an education credit

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DISTRIBUTIONS

P. 410

Nonqualified Distributions

- Taxable to the beneficiary
- Subject to a 10% excise tax
- Taxable amount determined by annuity taxation rules of I.R.C. 72
- Value, income, and investment in the contract determined as of the last day of the calendar year.

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EXAMPLE 11.8 TAXABLE DISTRIBUTION

P. 411

Kylie had a 529 plan. In 2024 she enrolled in college paying $10,000. $5,300 was from her 529 plan with a balance of $27,000.

Funds Used for Kylie's College Expenses

Source of Funds	Amount
Gift from parents	$ 1,600
Partial tuition scholarship (tax-free)	3,100
529 plan distribution	5,300
Total college expenses	$10,0 00

Adjusted Qualified Education Expenses

Total QHEE	$ 8,300
Tax-free educational assistance	(3,100)
Adjusted qualified educational expenses	$ 5,200

- $950 earnings × ($5,200 AQEE ÷ $5,300 distribution) = $932 tax-free earnings
- $950 earnings – $932 tax-free earnings = $18 taxable earnings

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EXAMPLE 11.9 COORDINATION WITH ED CREDITS

P. 411

Facts are the same as Example 11.8 except Kylie's parents claimed a $2,500 AOC. Thus, the calculation changes by adjusting her values

Kylie must include $735 in income

- $950 earnings × ($1,200 AQEE ÷ $5,300 distribution) = $215 tax-free earnings
- $950 earnings – $215 tax-free earnings = $735 taxable earnings

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POLLING QUESTION #3

529 Plan distributions are never taxable.

True False

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ADDITIONAL TAX P. 412

A 10% additional tax is imposed on non-qualified distributions if the taxable portion exceeds the AQEE. The 10% tax is imposed unless the distributions is:

- Made to a beneficiary on or after the death of the designated beneficiary
- Attributed to the designated beneficiary's disability

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ADDITIONAL TAX P. 412

- Made on account of a scholarship, allowance or payment to the extent the distribution does not exceed the scholarship, allowance or payment
- Made on account of the attendance of the designated beneficiary at an academy listed in I.R.C. § 530(d)(4)(B))iv) that doesn't exceed certain costs
- An amount includable in income solely because the QHEE were considered in determining the education credits

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ADDITIONAL TAX P. 412

Practitioner Note: IRA Distributions Qualifying for Exception

Also includes K-12 expenses up to $10,000

Example 11.10 IRA Distributions – No Additional Tax

Example 11.11 IRA Distributions – Additional Tax

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ROLLOVERS TO A ROTH IRA P. 413

After December 31, 2023, a new tax-free rollover is allowed to a ROTH IRA.

1. The 529 must be open for at least 15 years which end on the date of the rollover.
2. The rollover must be a trustee-to-trustee direct transfer to a ROTH for the beneficiary.
3. The rollover amount cannot exceed the aggregate amount contributed before the 5-year period ending on the date of the distribution.

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ROLLOVERS TO A ROTH IRA P. 413

4. The annual limitation cannot exceed the maximum IRA contribution amount applying to the designated beneficiary.
5. The aggregate limitation for the tax year and all prior years is $35,000.
6. The reduced ROTH IRA contribution limit based on AGI does not apply to rollovers from a 529 plan, although the general annual IRA contribution limit applies.

Example 11.12 Rollover ROTH IRA Limitation

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IMPACT ON FINANCIAL AID P. 413

Section 529 Plans Owned by the Student

Dependent Student

Is treated as accountable asset owned by the student's parent. Generally, this means a maximum of 5.64% on the student aid index (SAI)

Non-Dependent Student

with no dependents - reduces eligibility up to 20%

with dependents – reduces eligibility up to 3.29%

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IMPACT ON FINANCIAL AID P. 414

Section 529 Plans Owned by the Parent

- Treated on the FAFSA form as a countable asset owned by the parent
- meaning a maximum of 5.64% treated as part of SAI
- Sec 529 qualified distributions are not treated as income and excluded from SAI.

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IMPACT ON FINANCIAL AID P. 414

Section 529 Plans Owned by Another Person

- These plans are not included in either the students or parent's countable assets on the FAFSA form, thus not SAI includible.
- Additionally, any such distributions are not treated as student income.

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CANCELLATION-OF-DEBT INCOME
P. 415

If a loan is forgiven rather than paid in full by the taxpayer, then the taxpayer has an increase in wealth (balance sheet adjustment) because his or her obligation to repay the loan is reduced without an equal cash payment.

Unless an exclusion or exception applies, the borrower must include the amount as gross income.

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RECOGNITION OF CANCELLATION-OF-DEBT $$
P. 415

Cancellation-of-debt (COD) income is generally the difference between the outstanding balance owed and the amount accepted to satisfy the debt

If the lender repossesses property, the FMV of the property is treated as a cash payment

Example 11.13 Recognition of COD Income

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EXCEPTIONS TO COD INCOME
P. 415

Gifts or Inheritance
- Forgiveness of debt that is a gift is not treated as income.
- Donor may have to file a gift tax return.
- Canceled as a devise to the debtor, generally no COD income. (See Chp 2 – Trusts & Estates)

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EXCEPTIONS TO COD INCOME P. 416

Deductible debt -

Cash method taxpayer, if payment results in a deduction, COD is not included in gross income.

Example 11.14: Lost Deduction

Interest is a lost deduction

Principal is COD income

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EXCEPTIONS TO COD INCOME P. 416

Purchase Price Reduction

By Seller

Treated as a purchase price reduction and not COD

Reduces taxpayer's basis in the property

By financial institution

Treated as a loan modification, not a purchase price reduction

Example 11.15: Purchase Price Reduction

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EXCEPTIONS TO COD INCOME P. 416 - 417

Student Loan Cancellations

Usually included in gross income with 3 exclusions

- Work requirements are met
- Certain loan discharges in 2021 – 2025
- Loan repayment assistance program

Practitioner Note: State Tax Treatment

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EXCLUSIONS FROM COD INCOME PP. 417

Bankruptcy
- Exclusion from COD if debt is a title 11 bankruptcy case.
- The taxpayer individual must be the debtor.
- COD must be granted by the court.

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EXCLUSIONS FROM COD INCOME P. 417-418

Insolvency
- Defined as excess liabilities over the FMV of assets
- The taxpayer must be individually insolvent
- Assets exempt from collection must be included in the calculation.
- See Insolvency Worksheet (pg 418)

Example 11.16 Insolvency Less than Cancelled Debt

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EXCLUSIONS FROM COD INCOME P. 419

Qualified Farm Indebtedness
- Incurred directly in the taxpayers trade of business of farming
- Accounting for at least 50% of the aggregate gross receipts for the 3 years prior to the discharge
- Debt must be from a qualified entity.

- **Practitioner Note: Self-Employment Tax**

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EXCLUSIONS FROM COD INCOME P. 420

Qualified Real Property Business Indebtedness
- Rental Property
- Real estate developers
- Exclusion Limit

- **Practitioner Note: Election Requirement**

79

EXCLUSIONS FROM COD INCOME P. 421

Qualified Principal Residence Indebtedness
- Must be secured by the main home.
- For years 2021 – 2025, maximum amount is $750,000 ($325,000 for MFS)

- **Example 11.17 Qualified Principal Residence Indebtedness**

80

POLLING QUESTION #4

COD is always taxable.

True **False**

81

EXCLUSIONS FROM COD INCOME

P. 421

Ordering Rules for Exclusions if taxpayer qualifies for more than one.

- Bankruptcy
- Qualified principal residence debt
- Insolvency
- Qualified farm debt
- Qualified real property business debt

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EXCLUSIONS FROM COD INCOME

P. 421

The taxpayer may elect to apply the insolvency exclusion before the qualified principal residence debt exclusion if the taxpayer was insolvent immediately before the cancellation of qualified principal residence debt.

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REDUCTION IN TAX ATTRIBUTES

PP. 421-422

Taxpayer does not permanently avoid income taxes on excluded COD income.

Taxpayer defers the COD income by reducing tax attributes.

Taxpayer usually attaches Form 982 to their tax return.

Figure 11.7 Table 3 provides listing of the rules (pg 422).

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REDUCTION IN TAX ATTRIBUTES
P. 422

Qualified Principal Residence Indebtedness
- Taxpayer excludes COD income
- Taxpayer continues to own home
- Must reduce basis in the principal residence (but not below zero)

Example 11.18 Reducing Attributes in Principal Residence

85

REDUCTION IN TAX ATTRIBUTES
P. 423

Bankruptcy and Insolvency
- Ordered list of seven attributes which are to be applied
- Taxpayer may elect to reduce basis of depreciable property before reducing the other tax attributes.

Practitioner Note: Election to Treat Certain Real Property as Depreciable Property

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REDUCTION IN TAX ATTRIBUTES
P. 424-426

Example 11.19 Attribute Reduction – Insolvency

See Figure 11.10 for basis after reduction

Statement for 2024 Form 982, line 10a Dean Frazier
SSN XXX-XX-XXXX

Asset	Basis before Reduction	Allocation of Basis Reduction	Basis Reduction	Basis after Reduction
Office building	$ 60,000	Entire	$ 60,000	$ 0
Land under office building	90,000	Entire	90,000	0
Equipment	50,000	Entire	50,000	0
Real estate held for sale	5,000,000	$80,000 to each parcel	400,000	4,600,000
Total	$5,200,000		$600,000	$4,600,000

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REDUCTION IN TAX ATTRIBUTES P. 426

Basis Reduction Limits apply to bankrupt or insolvent taxpayers.

For personal use property the limit must be determined and is the least of

1. Bases of personal property held at the beginning of the year after the year of discharge,
2. Amount of cancelled nonbusiness debt which is excluded from income, or
3. The excess of the total basis of the property and the amount of money held immediately after cancellation over total liabilities immediately after the cancellation

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REDUCTION IN TAX ATTRIBUTES PP. 426 - 427

Taxpayer must reduce basis of each item of personal property proportionately.

Example 11.20 Basis Reduction Limit

Step 1 – Determine the amount of COD income

Step 2 – Determine if insolvent.

Step 3 – Calculate basis reduction limit

Step 4 – Reduce basis in each item of personal property

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REDUCTION IN TAX ATTRIBUTES P. 427

Qualified Farm Indebtedness

Order of qualified property reduction:

1. Depreciable qualified property (including real property held for sale to customers)
2. Land that is qualified property used in the T or B of farming
3. Other qualified property

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REDUCTION IN TAX ATTRIBUTES P. 427

Qualified Real Property Business Indebtedness

The only tax attribute reduced for COD income under this provision is the basis of depreciable real property. The basis reduction occurs at the earlier of:

1. The beginning of the tax year following the year of discharge
2. Immediately before a disposition of the property

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REPAYMENT OF CANCELED DEBTS P. 428

Taxpayer included a cancelled debt as income.
Taxpayer later paid the debt.
May be able to file a claim for refund in the year the amount was included as income.
Files on Form 1040X

The repayment is not a deduction in the year is it repaid.

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GAIN FROM TRANSFER OF ASSETS AND COD INCOME P. 428

Treasury Reg 1.1001-2(a)(1) – amount realized from a sale or disposition includes the liabilities that are discharged.
Two exceptions:

1. Recourse debt
2. Purchase-money debt

Example 11.21 Deed in Lieu of Foreclosure

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QUESTIONS?

94