

Elder Client PLANNER

Spidell's strategic tax advisor

More foreign asset (FATCA) guidance from the IRS

TAX: The IRS provides some surprising answers regarding what assets are (and are not) reportable on Form 8938.

By Tim Hilger, CPA
Editor

The IRS has posted Q&As on their website answering many of the most common questions regarding FATCA reporting (Form 8938, Statement of Specified Foreign Financial Assets).¹ In addition, Spidell recently concluded a webinar² on the subject and our attendees had a host of questions.

Here are some of the most common questions and the answers from both the IRS and Spidell.

Answers from the IRS

Q: Must a taxpayer report foreign real estate on Form 8938?

A: Foreign real estate is not a specified foreign financial asset required to be reported on Form 8938. For example, a personal residence or a rental property does not have to be reported.

If the taxpayer owns the property in his or her own name, reporting is not required.

Comment: The key to understanding FATCA reporting requirements is to keep in mind what asset the taxpayer actually owns. If the real estate is held through a foreign entity, such as a corporation, partnership, trust, or estate, then the taxpayer owns an interest in the foreign entity and that interest is a specified foreign financial asset that is reported on Form 8938.

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Mortgage limits apply on a per-residence basis

TAX: The Tax Court limited the deduction for unmarried co-owners with \$2.2 million of debt.

By Tim Hilger, CPA
Editor

Citing a Chief Counsel Advice,¹ the Tax Court has ruled that the \$1 million and \$100,000 home mortgage indebtedness limitations apply on a per-residence basis — not a per-taxpayer basis — when property is jointly owned by individuals who are not married.²

Facts

Charles Sophy and Bruce Voss bought two houses together as joint tenants and lived in both homes. In 2006 and 2007, the average total balances on the mortgages

secured by the two properties were \$2.2 million and \$500,000, respectively.

In 2006, Sophy paid and deducted \$94,698 in interest and Voss paid and deducted \$85,962. In 2007, the numbers were \$99,901 for Sophy and \$76,635 for Voss.

The IRS redetermined the deductible qualified residence interest for the two joint owners. See the table on page 3.

The arguments

The taxpayers argued that the limitations on indebtedness are properly applied on a per-taxpayer basis with respect to co-owners who are not married to each other. As such, they should each get to deduct the interest on \$1.1 million of indebtedness.

The IRS argued that the indebtedness limitations are properly applied on a

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levels. Taken literally, they would each imply that they are only to be applied at the per-property level. If so, this would mean that a taxpayer could deduct unlimited interest on an unlimited number of properties, so long as the debt on each does not exceed \$1.1 million.

Second, it seems presumptuous of the taxing authorities to determine

EXAMPLE 5-2: Jim, from the previous example, owns a second residence where he lives part-time with his children. The qualified indebtedness on the property is \$450,000, and Jim paid \$25,000 in interest on the property in 2011.

Since Jim's share of the qualifying indebtedness is \$550,000 on his principal residence and \$450,000 on his second residence, his total acquisition indebtedness is under \$1.1 million. Thus, it appears he can deduct the entire \$25,000 on the second residence.

COMMENT: Again, this can create an anomalous result. Suppose he was also co-owner of this property with Allison and that each made equal payments on the mortgage. In that case, according to the court in *Sophy*, neither Jim nor Allison would be entitled to deduct any interest on the second property.

what an individual may call a residence. "Residence" has a broader meaning than just the sticks and bricks that comprise a house (as it does in the tax law in determining the tax status of an individual living in the U.S. or elsewhere). There is no justification for treating A's choice of residence as a \$2 million house co-owned with B any differently than treating C's and D's choice to each purchase \$1 million homes.

Third, it's interesting that the court interpreted the lower limitation for married filing separate (\$550,000) as supporting its ruling that the limitation applies on a per-property basis rather than on a per-taxpayer basis as would seem apparent.

Suppose a married individual files a separate return and co-owns property with a single individual or a married couple that file a joint return. Which limitation applies to the property: the \$550,000 applicable to married filing separate or the \$1.1 million limitation applicable to single or married filing joint?

Fourth, if the \$1.1 million limitation attaches to the property, and if the taxpayer uses up only a portion of this limitation due to a co-ownership situation, does this entitle the taxpayer to use up the remainder of the limitation with acquisition indebtedness on a second

CAUTION: Regardless of whether the court's findings are flawed, the IRS will follow this decision.

home? The facts of *Sophy* go beyond the ruling in CCA 200911007. In that ruling, there was only a single residence with co-owners and a mortgage in excess of \$1.1 million.

If *Sophy* and *Voss* had each separately owned one of the two residences they co-owned, each would be entitled to up to \$1.1 million. The court did not explain why they didn't get two dips at the \$1.1 million limitation — one for each property. Why wasn't the "total qualified limit" in the IRS formula \$1.6 million (consisting of \$1.1 million on the first residence and \$500,000 on the second)? That result would keep both the per-property limits and the per-taxpayer limits under \$1.1 million (the per-taxpayer amount would be \$800,000, or 50% of \$1.6 million).

They also didn't explain what would happen with respect to the second residence if only one of them owned it. **S**

¹ CCA 200911007

² *Sophy v. Comm.* (2012) 138 TC 8

³ IRC §163(h)(3)(A)

Income tax reporting of trust income prior to funding

TRUST REPORTING: Trust assets don't automatically go into the trust at the death of the first spouse. Until then, who reports the income?

By Richard B. Malamud, CPA, J.D., LL.M.

Guest Contributor

There is no clear guidance on how to report income earned between the death of a taxpayer and funding the trusts. Here is an example and commonly used alternatives.

Abe and Mary Lee have community property held in the Lee revocable living trust dated June 25, 1998 (the "living trust"). On the first to die, the living trust states that the property is divided into three trusts as follows:

1. **Trust A:** The Lee marital deduction trust (QTIP trust). It consists of the decedent's share of the trust less \$5,120,000 (2012) — the current exemption amount.
2. **Trust B:** The Lee credit (shelter) trust. It has a value of \$5,120,000 (2012) less any property passing outside the trusts and prior taxable gifts.

3. **Trust C:** The living trust continues with the survivor's share of the property.

Any property not included in the living trust may have to be probated or distributed to the designated beneficiary or joint tenant.

The Lees' joint return in the year of death includes the decedent's income through the date of death and the survivor's income for the entire year. The real question that hasn't been answered by the IRS and is rarely addressed in articles is: When do the three separate trusts get funded for tax reporting purposes?

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This problem can best be illustrated by looking at an example. Suppose there are no prior taxable gifts and the couple's trust property consists solely of:

Residence	\$ 2,000,000
Stocks/bonds	<u>\$11,000,000</u>
Total	<u>\$13,000,000</u>

At the first death, the trusts should be funded as follows:

Trust A:	\$1,380,000 ($(\frac{1}{2} \times \$13,000,000) - \$5,120,000$) = 10.62%
Trust B:	\$5,120,000 = 39.38%
Trust C:	\$6,500,000 = 50.00%

The problems are:

1. When do these trusts get funded?
2. Which assets are placed into each trust? It is often the case that the surviving spouse gets title to 100% of the house rather than 50%.
3. Are distributions required prior to the funding of the separate trusts, is interest paid on specific bequests, etc.?
4. Which income tax returns are filed prior to funding of the various trusts?

As to item 4, the possible answers are:

- An administrative trust reports all income and distributions until items 1–3 are decided (half to the administrative trust and half to the surviving spouse as grantor); or
- All three trusts, plus a possible estate income tax return for the probate assets are treated as funded immediately at the date of death.

Administrative trust approach

If the administrative trust approach is used, there could be two trusts: one for the property in the living trust prior to death and one for any probate property that wasn't in the Living Trust. If there are two trusts, IRC §645 provides for an election (signed by the trustee and the executor and two TINs) to combine the living trust that functions as an estate with the probate estate for one estate fiduciary tax return.

This effectively allows the living trust during administration to select a fiscal year, and it exempts the "estate" from estimated taxes for its first two years. The administrative trust would report the decedent's share of the income and the survivor's share would be reported, but it would be treated as a grantor trust and pass through to the survivor on Schedule K-1. When Trusts A and B are funded, the administrative trust terminates.

35% on all income over \$11,350 (2011 tax rate schedule), except for qualified dividends and long term capital gains that are taxed at 15% or lower.

It may be possible to solve that problem by making distributions or making distributions within 65 days of year-end and electing to treat them as retroactive to the prior year. But the trustee and executors should check with the estate's lawyer to find out if that is permitted, especially if there are creditors.

"The administrative trust approach seems to make more sense. It should give the fiduciaries the time to decide how to allocate the assets..."

Immediate funding approach

If the immediate funding approach is used, it is not clear how the assets or income are allocated prior to the actual funding. Some commentators suggest that all income should be allocated on a *pro rata* basis from the date of death until funding is complete. In the above example, that would mean that the income would be allocated 50% to the survivor's grantor trust (assuming all assets are community property), and 10.62% to Trust A and 39.38% to Trust B as listed above. Others make their best guess and allocate income based on what they expect the final funding to be.

The administrative trust approach seems to make more sense. It should give the fiduciaries the time to decide how to allocate the assets and to deal with post-death appreciation or losses prior to funding the various trusts.

Even in this choice, the survivor's 50% share of the income continues to be taxable as a grantor trust. How that allocation is determined is not clear. What if, a year later, Trust C is funded with 100% of the residence? In that case, an allocation of 50% of the income exceeded the actual amount that really went into Trust C.

A major issue that arises with the administrative trust is that since it is a complex trust — because income is not required to be distributed — income can be trapped at the trust level if it is not distributed and will be taxed at

Surviving spouse

On the death of the surviving spouse, Trust A and Trust B terminate. The survivor's final return includes his or her income through date of death, plus any distributable or distributed income through date of death from Trust A and B. The same issue arises regarding funding of any trusts or administrative trust returns until the surviving spouse's assets are paid to the beneficiaries, which may include trusts for children, grandchildren, or charity.

Some people live in states that don't require probate. In that case, they use wills instead of trusts. When someone dies with a will, an estate is created for tax purposes and it files fiduciary income tax returns until it terminates by paying off all the debts and paying out the remainder to the beneficiaries, which may include a Trust A or B. In effect, it will be very similar to an administrative trust. §

About the author

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