Halcolm Bard
Certified Public Accountant & Consultants

TAX AND BUSINESS ADVISOR

Visit our web page at www.halcolm.com

Tax and Business Alert™

April 2010

Taxation of Long-term Care Insurance Proceeds

A qualified long-term care insurance contract is generally treated as an accident and health insurance contract for income tax purposes. Amounts received under a qualified long-term care insurance contract (other than policyholder dividends or premium refunds) may be excludable from income as amounts received for personal injury and sickness. The premiums on long-term care insurance contracts and the expenses of qualified long-term care are treated as medical expenses.

Example: Income exclusion for long-term care insurance payments.

Joe is confined to a nursing home for 30 days in 2010. The nursing home charges $210 per day, for a total of $6,300. Joe's long-term care insurance contract pays 80% of the amount charged by the home after a 10-day waiting period, so the insurance company sends him a check for $3,360 {[$6,300 – (10 × $210)] × 80%}. The $3,360 is excluded from Joe's 2010 taxable income. Furthermore, Joe can deduct the $2,940 unreimbursed difference ($6,300 – $3,360) as a medical expense, subject to the adjusted gross income limitation.


Photos.com

Some long-term care insurance contracts pay a certain amount per day, regardless of the actual long-term care costs. However, the exclusion from taxable income is limited. For 2010, the excludable amounts are $290 per day or $105,850 ($290 × 365) for the year. However, long-term care insurance proceeds received on a per diem basis can be excluded from income (even if they exceed the limits) if the taxpayer has long-term care expenses in excess of the cap. For example, there would be no income to the taxpayer if the policy paid $300 per day and the cost of the long-term care facility was that amount or more. Otherwise, amounts received in excess of the dollar cap are fully taxable. However the per diem limitation does not apply if the taxpayer is terminally ill when the insurance payments are received.

Tax Calendar

April 15—Besides being the last day to file (or extend) your 2009 personal return and pay any tax that is due, 2010 first quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due today. So are 2009 returns for trusts and calendar-year estates, partnerships, and LLCs, plus any final contribution you plan to make to an IRA or Education Savings Account for 2009. SEP and Keogh contributions are also due today if your return is not being extended.

—If you need to file a 2009 gift tax return, it also must be filed or extended by this date.

—If you paid cash wages of $1,700 or more in 2009 to a household employee, you must file Schedule H by this date. You may also have to report any federal unemployment tax paid and any income tax you withheld for your household employees.

April 30—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through March 31 exceeds $500.

—Most employers must file Form 941 (Employer's Quarterly Federal Tax Return) to report Medicare, social security, and income taxes withheld in the first quarter of 2010. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until May 10 to file the return.

June 15—Second quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due today.

National Taxpayer Advocate Reports to Congress

In her recent report to Congress, National Taxpayer Advocate Nina Olson warned that increased demands on the IRS have eroded the Service's ability to meet taxpayer service needs, and she expressed concern that IRS collection practices have harmed financially struggling taxpayers without producing significant revenue gains. She indicated the IRS's declining ability to answer telephone calls and the current (automated) tax lien filing procedures as the most serious problems facing taxpayers. Olson noted that the IRS has set a target for FY 2010 of answering only 71% of calls from taxpayers seeking to speak with a customer service representative about account questions, down from 83% in FY 2007. "This level of service is unacceptable," she noted.


Photos.com

Among other topics, the report questioned the IRS's "pay refunds first, verify eligibility later" approach to return processing and the wisdom of running social programs through the tax system. On a positive note, Olson praised the IRS for successfully implementing significant legislative changes designed to stimulate the economy in the midst of the filing season.

Medical Deduction for Personal Care Products

A recent IRS information release contains some practical guidance concerning the deduction of some personal care items as medical expenses. Although the information release does not constitute an official ruling, it does guide taxpayers concerning deductibility of certain items. The release states that two of the factors indicating that an otherwise personal expense is for medical care are the taxpayer's reason for buying the item and whether a physician has recommended the item to treat a diagnosed medical condition. The taxpayer also must establish that the item would not have been bought but for the disease or illness. This information release notes that

(Continued on page 3.)

◇ Corporations◇LLCs◇Proprietorships◇Bookkeeping & Payroll◇Taxes◇Businesses & Individuals◇Financial Statements◇
Halcolm Bard CPA • 38 Fraley Street • Kane, Pennsylvania 16735 • (814) 837-9150 • Tax and Business Advisor

Reduction of Seller-financed Debt

Many residential and commercial real estate owners have experienced a reduction in property values during the recent economic downturn. So much so that owners may want to renegotiate the original purchase terms of seller-financed real estate deals. In this situation, a special rule may apply when seller-financed (i.e., purchase money) debt on the property purchased is reduced. This rule applies only if the creditor is the original seller of the property, the debt arose from the debtor's purchase of the property, and the purchaser (debtor) would recognize debt discharge income except for this provision (i.e., the purchaser is not bankrupt or insolvent and did not make a qualified real property debt election).

If these conditions are satisfied, the purchaser reduces the basis in the property acquired with the seller-financed debt and does not recognize debt discharge income (see the example below). This treatment is not elective; it is mandatory if the three requirements listed in the previous paragraph are met.

Example: Reduction of seller-financed residential mortgage.

Stella bought her residence from Fran in 2006 for $135,000. Fran financed the transaction by taking back a $125,000 recourse mortgage from Stella in addition to receiving a $10,000 cash down payment. Fran's basis in the property at the time of sale was $75,000. Fran uses the installment method to recognize her profit on the sale over the period of time she receives payments from Stella. Stella made her payments to Fran until early 2010. She then threatened to abandon the property unless Fran reduced the remaining mortgage debt because the property had substantially decreased in value.

Fran agreed to reduce the remaining balance of Stella's mortgage from $121,000 to $100,000, and Stella agreed to make payments to Fran under a revised loan amortization schedule. Stella was solvent at the time of the debt reduction.


Photos.com

Stella must reduce her basis in the home by $21,000 to reflect the reduction in the purchase money debt owed to Fran. Stella does not recognize any debt discharge income because the debt arose from the purchase of the property, the original seller of the property held the obligation that was reduced, and Stella was solvent at the time.

So, there is no immediate tax impact on Stella resulting from the renegotiated transaction.

Regulatory guidance indicates that both parties must reflect any adjustment to seller-financed debt for tax basis purposes, so Fran must also make an adjustment to reflect the new terms. She has been recognizing her profit over time, as payments are received, using the installment method. In this case, there are no immediate tax ramifications on Fran. But she must recompute, and in this case lower, the profit percentage of each payment to reflect the $21,000 ($121,000 – $100,000) seller-financed mortgage reduction. Accordingly, the tax impact will occur over the term of the loan as Fran receives payments from Stella.

As with most business transactions, it is a good policy to review the tax and legal aspects prior to closing. So, please call us to discuss any business tax planning or compliance issue.

Medical Deduction for Personal Care Products

(Continued from page 2.)

treatments for acne, incontinence, arthritis, sinus problems, dehydration, indigestion, and support for injured or weakened body parts most likely qualify as medical care. Products that treat existing skin conditions (rather than preventing the development of the condition), such as eczema treatments, also should qualify as medical care.

Deducting Interest on S Corporation Stock Debt

Photos.com

Maximizing deductible interest expense is generally a good tax planning strategy for most taxpayers. One category of interest expense that can be deductible is interest paid on debt to finance the purchase of S corporation stock. Specifically, interest on shareholder-level debt used to purchase S corporation stock from another shareholder (i.e., the corporation does not receive the cash) can qualify as deductible business interest if certain conditions are satisfied. In contrast, interest expense on debt used to finance the purchase of stock in a C corporation is considered investment interest because the debt proceeds are used to acquire property (C corporation stock) that generates investment income (dividends) to the shareholder.

Interest expense on debt incurred to purchase stock in an S corporation may be treated as deductible business interest when certain conditions are met. As a result of applying debt allocation procedures, the shareholder's debt will be attributed to the S corporation's trade or business, passive activities, or investment activities. The shareholder's interest expense will then be subject to the specific rules applicable to each category. (See the following example.)

Example: Acquisition of S corporation stock from another shareholder.

Using borrowed money, Linda acquired 5% of the outstanding stock in Essco, Inc., an S corporation, from Leon for $25,000. Linda incurred $3,000 of interest expense on the loan. The corporation manufactures hydraulic hose assemblies and owns manufacturing equipment with a fair market value (FMV) of $200,000. Linda materially participates in the business and there have been no debt-financed distributions.

Accordingly, Linda could allocate her $25,000 debt to the S corporation's manufacturing equipment. As a result, Linda's $3,000 interest expense is treated as a business interest expense.

Note that debt proceeds must be reallocated among the S corporation's assets as either the assets or the use of the assets changes. So, the allocation could change from year to year.

Please contact us if you have questions related to the deductibility of interest or any other tax planning or compliance issue.