Chapter 1: Individual Taxpayer Problems

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Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

PROBLEM 1: RETIREMENT SAVINGS CONTRIBUTIONS CREDIT (FORM 8880)

BACKGROUND INFORMATION

The EGTRRA of 2001 added IRC §25B, which is commonly called the Retirement Savings Contribution Credit, or simply the Saver's Credit. The legislation provides a **temporary** (effective for tax years 2002 through 2006) **nonrefundable credit** to low-income and middle-income taxpayers as an incentive to create or add to their retirement plans. The formula for computing the credit is complex, especially if retirement plan **distributions** are received during the **testing period**. The credit is computed on **Form 8880**, *Credit for Qualified Retirement Savings Contributions.* This credit came as a pleasant surprise on 2002 individual returns to both qualified taxpayers and many of their tax preparers.

WHO MAY CLAIM THE CREDIT

Taxpayers may be entitled to the credit if they, or their spouse, if filing jointly, make:

- **Contributions** (other than rollover contributions) to a **traditional or a Roth IRA**,
- **Elective deferrals** to §401(k) plans, §403(b) tax-sheltered annuities, §457 plans for state or local government employees, salary reduction SEP plans, or SIMPLE IRA plans, or
- **Voluntary after-tax employee contributions** to a qualified retirement plan or a §403(b) tax-sheltered annuity.

WHO MAY NOT CLAIM THE CREDIT

Taxpayers may not claim the credit if any of the following conditions apply:

- Adjusted Gross Income (AGI) exceeds **$25,000** (if single or married filing separately), **$37,500** (if head of household), or **$50,000** (if married filing jointly),
- The taxpayer is **under age 18** as of the close of the taxable year,
- The taxpayer is **claimed as a dependent** on someone's (such as a parent's) return, or
- The taxpayer is a **student** (as defined in §151(c)(4)).

REDUCTIONS TO THE CONTRIBUTIONS ELIGIBLE FOR THE CREDIT

If a taxpayer makes **2002–2006 contributions** to IRAs (traditional or Roth) or **2002–2006 elective deferrals** and **does not receive any taxable distributions** from such plans during the **testing period**, the computation on Form 8880 is fairly simple. If distributions are received during the testing period, the amount of contributions to IRAs and elective deferrals eligible for the credit must be reduced (but not below zero).

Line 4 on Form 8880 is used to report these distributions. The Line 4 Instructions explain the rules for retirement distributions received during the testing period. For many pre-retirement age low- and middle-income taxpayers, this **reduction will not be a factor** in computing the allowable credit on Form 8880. For more information, see the General Instructions for Line 4 on page 2 of Form 8880 (not shown).

Note. The testing period consists of:

- The two tax years before the tax year in which the saver's credit is claimed,
- The tax year in which the saver's credit is claimed, and
- The period after the end of that tax year that is before the due date for filing the return.

Example 1. George and Laura will file a joint 2003 return. Laura contributed $3,000 to her traditional IRA for 2003. George withdrew $6,000 from his 401(k) plan in 2001.

Tax Solution to Example 1. Since George's withdrawal exceeds Laura's contribution, Laura is not eligible for the retirement savings credit for 2003. There is no need to include a 2003 Form 8880 with their 2003 Form 1040.

AMOUNT OF THE NONREFUNDABLE CREDIT ON FORM 8880

The amount of the **maximum $1,000** (per taxpayer) Saver's Credit depends on the **filing status** and the **AGI** of the taxpayer(s). The credit rate can be as high as 50% or as low as 10%. Married taxpayers who file jointly can qualify for a **maximum $2,000** nonrefundable credit ($1,000 each).

Example 2. Following are observations related to **Example 2** which contains a completed 2003 Form 1040 and related forms and schedules for Sarah Scott.

Observation 1. The taxpayer, Sarah, a teacher's aide, is a divorced mother who qualifies as head of household in 2003.

Observation 2. She made a $2,000 contribution to her traditional IRA in 2003 and received no distributions from her IRA or other retirement plans during the testing period for 2003.

Observation 3. Because her 2003 AGI is $22,824, Sarah's credit rate is 20% as shown in the chart below Line 9 on the 2003 Form 8880. The fourth line on that chart and her filing status are boxed for reference. See page 7 for Sarah's completed Form 8880.

Observation 4. If Sarah's 2003 AGI was only **$324 less**, her credit rate would be the maximum 50% and her credit on Line 10, Form 8880 **would have been the maximum $1,000.** However, in that scenario, the nonrefundable $1,000 credit would be **limited to her $823 tax** as shown on line 43 on her Form 1040.

Observation 5. Sarah's $400 saver's credit on Form 8880 **has no effect on her refundable earned income credit of $1,093.** A **refundable** credit, such as the earned income credit or the refundable portion of the child tax credit, will be received by a taxpayer even if the total tax figure (line 61 on the 2003 Form 1040) is zero.

Observation 6. Sarah had no other 2003 **nonrefundable** credits such as the Hope or Lifetime Learning Credits. However, if she did and if her Education Credits on the 2003 Form 8863 exceeded her $823 tax liability, she would **not** be entitled to any Saver's Credit for 2003.

For Example 2

Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2003 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2003, or other tax year beginning , 2003, ending , 20 — OMB No. 1545-0074

Label (See instructions on page 21.)
Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial: Sarah J.	Last name: Scott	Your social security number: 333 : 33 : 3333
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 21.: 203 Oak Street	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 21.: Paw Paw, IL 61353		

Presidential Election Campaign (See page 21.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☐ Yes ☒ No Spouse ☐ Yes ☐ No

Filing Status
Check only one box.
1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☒ Head of household (with qualifying person). (See page 21.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child. (See page 21.)

Exemptions
6a ☒ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a — No. of boxes checked on 6a and 6b: 1
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 22)
Kristen Scott	222 : 22 : 2222	Daughter	☐
			☐
			☐
			☐
			☐

If more than five dependents, see page 22.

No. of children on 6c who:
• lived with you: 1
• did not live with you due to divorce or separation (see page 22)
Dependents on 6c not entered above
d Total number of exemptions claimed — Add numbers on lines above ▶ 2

Income
Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.
If you did not get a W-2, see page 23.
Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	22,398
8a	**Taxable** interest. Attach Schedule B if required	8a	435
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends (see page 25) — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 25)	10	587
11	Alimony received	11	1,454
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13a	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13a	
b	If box on 13a is checked, enter post-May 5 capital gain distributions — 13b		
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions — 15a; b Taxable amount (see page 25)	15b	
16a	Pensions and annuities — 16a; b Taxable amount (see page 25)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits — 20a; b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	24,874

Adjusted Gross Income

23	Educator expenses (see page 29)	23	50		
24	IRA deduction (see page 29)	24	2,000		
25	Student loan interest deduction (see page 31)	25			
26	Tuition and fees deduction (see page 32)	26			
27	Moving expenses. Attach Form 3903	27			
28	One-half of self-employment tax. Attach Schedule SE	28			
29	Self-employed health insurance deduction (see page 33)	29			
30	Self-employed SEP, SIMPLE, and qualified plans	30			
31	Penalty on early withdrawal of savings	31			
32a	Alimony paid b Recipient's SSN ▶	32a			
33	Add lines 23 through 32a			33	2,050
34	Subtract line 33 from line 22. This is your **adjusted gross income** ▶			34	22,824

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 76. Cat. No. 11320B Form **1040** (2003)

For Example 2

Form 1040 (2003) Page **2**

Tax and Credits

35	Amount from line 34 (adjusted gross income)			35	22,824
36a	Check if: ☐ **You** were born before January 2, 1939, ☐ Blind. ☐ **Spouse** was born before January 2, 1939, ☐ Blind. Total boxes checked ▶ 36a				
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 34 and check here ▶ 36b ☐				
37	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			37	8,484
38	Subtract line 37 from line 35			38	14,340
39	If line 35 is $104,625 or less, multiply $3,050 by the total number of exemptions claimed on line 6d. If line 35 is over $104,625, see the worksheet on page 35			39	6,100
40	**Taxable income.** Subtract line 39 from line 38. If line 39 is more than line 38, enter -0-			40	8,240
41	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972			41	823
42	**Alternative minimum tax** (see page 37). Attach Form 6251			42	
43	Add lines 41 and 42 ▶			43	823
44	Foreign tax credit. Attach Form 1116 if required	44			
45	Credit for child and dependent care expenses. Attach Form 2441	45			
46	Credit for the elderly or the disabled. Attach Schedule R	46			
47	Education credits. Attach Form 8863	47			
48	Retirement savings contributions credit. Attach Form 8880	48	400		
49	Child tax credit (see page 39)	49			
50	Adoption credit. Attach Form 8839	50			
51	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	51			
52	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify ______	52			
53	Add lines 44 through 52. These are your **total credits**			53	400
54	Subtract line 53 from line 43. If line 53 is more than line 43, enter -0- ▶			54	423

Standard Deduction for—

- People who checked any box on line 36a or 36b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $4,750

Married filing jointly or Qualifying widow(er), $9,500

Head of household, $7,000

Other Taxes

55	Self-employment tax. Attach Schedule SE	55	
56	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	56	
57	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	57	
58	Advance earned income credit payments from Form(s) W-2	58	
59	Household employment taxes. Attach Schedule H	59	
60	Add lines 54 through 59. This is your **total tax** ▶	60	423

Payments

61	Federal income tax withheld from Forms W-2 and 1099	61	1,200		
62	2003 estimated tax payments and amount applied from 2002 return	62			
63	**Earned income credit (EIC)**	63	1,093		
64	Excess social security and tier 1 RRTA tax withheld (see page 56)	64			
65	Additional child tax credit. Attach Form 8812	65			
66	Amount paid with request for extension to file (see page 56)	66			
67	Other payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	67			
68	Add lines 61 through 67. These are your **total payments** ▶			68	2,293

If you have a qualifying child, attach Schedule EIC.

Refund

Direct deposit? See page 56 and fill in 70b, 70c, and 70d.

69	If line 68 is more than line 60, subtract line 60 from line 68. This is the amount you **overpaid**			69	1,870
70a	Amount of line 69 you want **refunded to you** ▶			70a	1,870
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings				
▶ d	Account number				
71	Amount of line 69 you want **applied to your 2004 estimated tax** ▶	71			

Amount You Owe

72	**Amount you owe.** Subtract line 68 from line 60. For details on how to pay, see page 57 ▶			72	
73	Estimated tax penalty (see page 57)	73			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 58)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 21. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number ( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no.	( )

Form **1040** (2003)

For Example 2

SCHEDULES A&B (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
2003
Attachment Sequence No. 07

Name(s) shown on Form 1040: Sarah J. Scott
Your social security number: 333 33 3333

Medical and Dental Expenses		Caution. Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-2)	1			
	2	Enter amount from Form 1040, line 35 [2]				
	3	Multiply line 2 by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	
Taxes You Paid (See page A-2.)	5	State and local income taxes	5	468		
	6	Real estate taxes (see page A-2)	6	1,527		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	1,995
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	5,124		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12			
	13	Investment interest. Attach Form 4952 if required. (See page A-3.)	13			
	14	Add lines 10 through 13			14	5,124
Gifts to Charity If you made a gift and got a benefit for it, see page A-4.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4	15	1,200		
	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **must** attach Form 8283 if over $500	16			
	17	Carryover from prior year	17			
	18	Add lines 15 through 17			18	1,200
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19	
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. You **must** attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶ **NEA Dues $521**	20	521		
	21	Tax preparation fees	21	100		
(See page A-5 for expenses to deduct here.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
	23	Add lines 20 through 22	23	621		
	24	Enter amount from Form 1040, line 35 [24] 22,824				
	25	Multiply line 24 by 2% (.02)	25	456		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26	165
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶			27	
Total Itemized Deductions	28	Is Form 1040, line 35, over $139,500 (over $69,750 if married filing separately)? ☒ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 37. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ▶			28	8,484

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2003**

For Example 2

SCHEDULE EIC (Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit

Qualifying Child Information

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

1040A 1040 EIC

OMB No. 1545-0074

2003

Attachment Sequence No. **43**

Name(s) shown on return: **Sarah J. Scott**

Your social security number: **333 33 3333**

Before you begin: See the instructions for Form 1040A, line 41, or Form 1040, line 63, to make sure that **(a)** you can take the EIC and **(b)** you have a qualifying child.

CAUTION

- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information	Child 1	Child 2
1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name / Last name: **Kristen Scott**	First name / Last name:
2 Child's SSN The child must have an SSN as defined on page 44 of the Form 1040A instructions or page 46 of the Form 1040 instructions unless the child was born and died in 2003. If your child was born and died in 2003 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	**222 22 2222**	

Next, if the child was born after 1984, go to line 4. Otherwise, continue.

	Child 1	Child 2
3 If the child was born before 1985— **a** Was the child under age 24 at the end of 2003 and a student?	☐ **Yes.** *Go to line 4.* ☐ **No.** *Continue*	☐ **Yes.** *Go to line 4.* ☐ **No.** *Continue*
b Was the child permanently and totally disabled during any part of 2003?	☐ **Yes.** *Continue* ☐ **No.** The child is not a qualifying child.	☐ **Yes.** *Continue* ☐ **No.** The child is not a qualifying child.
4 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	**Daughter**	
5 Number of months child lived with you in the United States during 2003 • If the child lived with you for more than half of 2003 but less than 7 months, enter "7". • If the child was born or died in 2003 and your home was the child's home for the entire time he or she was alive during 2003, enter "12".	**12** months *Do not enter more than 12 months.*	____ months *Do not enter more than 12 months.*

TIP

You may also be able to take the additional child tax credit if your child **(a)** was under age 17 at the end of 2003, **(b)** is claimed as your dependent on line 6c of Form 1040A or Form 1040, **and (c)** is a U.S. citizen or resident alien. For more details, see the instructions for line 42 of Form 1040A or line 65 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 2003**

For Example 2

Form **8880** — Department of the Treasury, Internal Revenue Service

Credit for Qualified Retirement Savings Contributions

▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1805 | 2003 | Attachment Sequence No. 129

Name(s) shown on return: Sarah J. Scott | Your social security number: 333 33 3333

CAUTION

You **cannot** claim this credit if any of the following apply.

- The amount on Form 1040, line 35, or Form 1040A, line 22, is more than $25,000 ($37,500 if head of household, $50,000 if married filing jointly).
- The person(s) who made the qualified contribution or elective deferral **(a)** was born after January 1, 1986, **(b)** is claimed as a dependent on someone else's 2003 tax return, or **(c)** was a **student** in 2003.

			(a) You		(b) Your spouse
1	Traditional and Roth IRA contributions for 2003. **Do not** include rollover contributions	1	2,000		
2	Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18) plan contributions for 2003 (see instructions)	2			
3	Add lines 1 and 2	3	2,000		
4	Certain distributions received **after** 2000 and **before** the due date (including extensions) of your 2003 tax return (see instructions). If married filing jointly, include **both** spouses' amounts in **both** columns. See instructions for an exception	4			
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	2,000		
6	In each column, enter the **smaller** of line 5 or $2,000	6	2,000		
7	Add the amounts on line 6. If zero, **stop**; you cannot claim the credit			7	2,000
8	Enter the amount from Form 1040, line 35*, or Form 1040A, line 22	8	22,824		
9	Enter the applicable decimal amount shown below:			9	X . 20

If line 8 is—		And your filing status is—		
Over—	But not over—	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
		Enter on line 9—		
---	$15,000	.5	.5	.5
$15,000	$16,250	.5	.5	.2
$16,250	$22,500	.5	.5	.1
$22,500	$24,375	.5	.2	.1
$24,375	$25,000	.5	.1	.1
$25,000	$30,000	.5	.1	.0
$30,000	$32,500	.2	.1	.0
$32,500	$37,500	.1	.1	.0
$37,500	$50,000	.1	.0	.0
$50,000	---	.0	.0	.0

Note: *If line 9 is zero,* ***stop****; you cannot claim the credit.*

10	Multiply line 7 by line 9			10	400
11	Enter the amount from Form 1040, line 43, or Form 1040A, line 28	11	823		
12	Enter the total of your credits from Form 1040, lines 44 through 47, or Form 1040A, lines 29 through 31	12			
13	Subtract line 12 from line 11. If zero, **stop**; you cannot take the credit			13	823
14	**Credit for qualified retirement savings contributions.** Enter the **smaller** of line 10 or line 13 here and on Form 1040, line 48, or Form 1040A, line 32			14	400

*See Pub. 590 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 33394D Form **8880** (2003)

> **Note.** See pages 36–37 and 370–371 in the *2002 University of Illinois Income Tax Workbook* for more information on this topic.

PROBLEM 2: EXCLUSION OF GAIN ON SALE OF PRINCIPAL RESIDENCE

[Treasury Decision 9030 (Final Regulations) and Treasury Decision 9031 (Temporary Regulations) pertaining to §121]

BACKGROUND INFORMATION

On December 23, 2002, the IRS issued two Treasury Decisions regarding the provisions of IRC §121. The home sale exclusion was made more favorable.

These two Treasury Decisions apply to home sales **after December 23, 2002.** However, the new rules can be applied retroactively to **home sales on or after May 7, 1997,** provided the period for filing an amended return has not expired for the year of sale. For practical purposes, the result (as of late October 2003) is that amended individual returns can be filed for 2000, 2001, and 2002 to take advantage of these new liberal provisions.

> **Note.** If the **total gain on the home-office portion** of a principal residence sale has been reported on the 2000, 2001, or 2002 Forms 4797 without regard to the new regulations, amended returns (Forms 1040X) should be filed to take advantage of the new protaxpayer rules.
>
> In addition, taxpayers who thought they didn't qualify for the **reduced (prorated) maximum exclusion under prior rules may now qualify under the new rules**.
>
> The two cited Treasury Decisions could result in a substantial number of amended returns requesting refunds.

PARTIAL BUSINESS USE OR RENTAL OF HOME

Under Treasury Decision 9030, the **prior rule is eliminated** which requires that the sale of a dual-use home (used partly as a residence and partly for business or rental) be reported as the **sale of two properties (one personal and the other business).** The tax result of the prior rule was likely to be substantial because the separate sale of the home-office portion of the home was required to be reported on Form 4797. Under prior rules, the taxable gain on the **home-office portion** of the sale included two factors:

- The increase in value during the time owned, and
- The add-back of depreciation claimed on the home-office portion.

Under Treasury Decision 9030 and the guidance provided in IRS Pub. 523, ***Selling Your Home*** (For Use in Preparing 2002 Returns), the sale is **no longer required to be allocated** between personal and business uses. This new rule applies if two conditions are met:

1. The dual two-out-of-five-years ownership and use tests are met for the personal residential use portion of the home.
2. **Both** the business and/or rental use and the personal residential use are **within the same dwelling unit.**[1]

However, any gain due to depreciation (MACRS) taken on the business portion after May 6, 1997, must be recaptured as IRC §1250 gain. The tax result is that the portion of the gain due to post-May 6, 1997, depreciation is taxed at a maximum 25% tax rate as unrecaptured §1250 gain.[2]

> **Note.** Treasury Decision 9030 permits the business use or rental use portion of the residence to qualify for the liberal exclusion under IRC §121 **except for depreciation taken after May 6, 1997**. This post-May 6, 1997, depreciation is **never** excludable, assuming that there is an overall gain on the sale of the home (including the business use or rental use portion).

Example 3. Roger, who is single, owned and used a house located in St. Louis as his principal residence from 1997 through 2000. On January 1, 2001, he moved to Chicago. He rented the St. Louis house from January 1, 2001, through April 30, 2003, when he sold it. He claimed $6,000 of MACRS depreciation on the home during the rental period. His total gain on the 2003 sale was **$50,000, of which $6,000 was due to MACRS depreciation recapture.**

Question A. Has Roger met the dual two-out-of-five ownership and use tests for the residence?

Answer A. Yes. He owned and lived in the home for **32 months** during the 5-year period ending on the date of sale on April 30, 2003 (May 1, 1998, through April 30, 2003).

> **Note.** He **used the home as a residence** during this 5-year period for 8 months in 1998, 12 months in 1999, and 12 months in 2000, for a total of **32 months** (more than 2 years).

Question B. How much of Roger's $50,000 gain on the sale is excludable on his 2003 return?

Answer B. Roger is allowed to exclude $44,000 of the total $50,000 gain on the sale under the final regulations for IRC §121. He may not exclude $6,000 of the gain which is due to depreciation allowed or allowable after May 6, 1997.

> **Note.** All of the $6,000 of MACRS depreciation claimed on the rental house was after May 6, 1997.

Question C. How and where does Roger report this sale on his 2003 tax return?

Answer C. He reports it on his 2003 Form 4797 since it was rented in the year of sale. A portion of the Instructions for the 2002 Form 4797 follows:

Exclusion of Gain on Sale of a Home Used for Business

If the property sold was used for business or to produce rental income and was also owned and used as your home during the 5-year period ending on the date of the sale, you may be able to exclude part or all of the gain figured on Form 4797. For details on the exclusion, see Pub. 523, Selling Your Home.

If the property was held more than 1 year, complete Part III to figure the amount of the gain. Do not take the exclusion into account when figuring the gain on line 24. If line 22 includes depreciation for periods after May 6, 1997, you cannot exclude gain to the extent of that depreciation. On line 2 of Form 4797, write "Section 121 exclusion" and enter the amount of the exclusion as a (loss) in column (g).

If the property was held for 1 year or less, report the sale and the amount of the exclusion, if any, in a similar manner on line 10 of Form 4797.

Example 3 for Roger concludes with four completed items (shown in the following order):

- **Worksheet 2** from IRS Pub. 523, ***Selling Your Home*** (For Use in Preparing 2002 Returns), **Gain (or Loss), Exclusion, and Taxable Gain**
- Roger's **2003 Form 4797**
- Roger's **2003 Schedule D**
- **Schedule D Tax Worksheet — Line 53** (from the 2003 Form 1040 Instructions)

Worksheet 2. **Gain (or Loss), Exclusion, and Taxable Gain**

Part 1 – Gain (or Loss) on Sale			
1.	Selling price of home	**1.**	198,000
2.	Selling expenses	**2.**	3,000
3.	Subtract line 2 from line 1	**3.**	195,000
4.	Adjusted basis of home sold (from *Worksheet 1*, line 13) **Worksheet 1 NOT SHOWN**	**4.**	145,000
5.	Subtract line 4 from line 3. This is the **gain (or loss)** on the sale. If this is a loss, stop here	**5.**	50,000
Part 2 – Exclusion and Taxable Gain			
6.	Enter any depreciation allowed or allowable on the property for periods after May 6, 1997. If none, enter zero	**6.**	6,000
7.	Subtract line 6 from line 5. (If the result is less than zero, enter zero.)	**7.**	44,000
8.	If you qualify to exclude gain on the sale, enter your maximum exclusion. (See *Maximum Amount of Exclusion* earlier.) If you do not qualify to exclude gain, enter -0-	**8.**	250,000
9.	Enter the smaller of line 7 or line 8. This is your **exclusion**	**9.**	44,000
10.	Subtract line 9 from line 5. This is your **taxable gain.** Report it as described under *Reporting the Gain* on page 16. If the amount on this line is zero, do not report the sale or exclusion on your tax return. **If the amount on line 6 is more than zero, complete line 11**	**10.**	6,000
11.	Enter the smaller of line 6 or line 10. Enter this amount on line 12 of the *Unrecaptured Section 1250 Gain Worksheet* in the instructions for Schedule D (Form 1040) **Worksheet NOT SHOWN**	**11.**	6,000

Note. Regarding line 11 on Worksheet 2, the Unrecaptured Section 1250 Gain Worksheet (for line 19, Schedule D) from the 2003 Form 1040 Instructions is not shown. However, the figure on line 17 of that Worksheet is **$6,000**.

For Example 3

Form 4797 (2003) Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Rental home located in St. Louis, MO	03/12/1997	04/30/2003
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ►		**Property A**	**Property B**	**Property C**	**Property D**
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	198,000			
21 Cost or other basis plus expense of sale	21	154,000			
22 Depreciation (or depletion) allowed or allowable	22	6,000			
23 Adjusted basis. Subtract line 22 from line 21	23	148,000			
24 Total gain. Subtract line 23 from line 20	24	50,000			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a	0			
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	50,000
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	0
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6, column (g), and if applicable, column (h)	32	50,000

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (See instructions.)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2003)

For Example 3

Form **4797** — Department of the Treasury, Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

► Attach to your tax return. ► See separate instructions.

OMB No. 1545-0184 — 2003 — Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Roger	111-11-1111

1 Enter the gross proceeds from sales or exchanges reported to you for 2003 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) **1**

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (See instructions.)

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) for entire year Subtract (f) from the sum of (d) and (e)	(h) Post-May 5, 2003, gain or (loss)* (see below)
2							
Sect. 121 Exclusion						(44,000)	

		(g)	(h)
3	Gain, if any, from Form 4684, line 39		
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37		
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824		
6	Gain, if any, from line 32, from other than casualty or theft	50,000	
7	Combine lines 2 through 6 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:	6,000	

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.

All others. If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.

		(g)	(h)
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	0	
9	Subtract line 8 from line 7. If line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)	6,000	

*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain **and** the amount, if any, on line 8, column (g), does **not** exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) **after** May 5, 2003. However, do **not** include gain attributable to unrecaptured section 1250 gain.

Part II **Ordinary Gains and Losses**

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11	Loss, if any, from line 7, column (g)	( )
12	Gain, if any, from line 7, column (g) or amount from line 8, column (g), if applicable	
13	Gain, if any, from line 31	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	
18	Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows:	

a **For all except individual returns.** Enter the gain or (loss) from line 18 on the return being filed.

b **For individual returns:**

(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions . . **18b(1)**

(2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14 . . . **18b(2)**

For Paperwork Reduction Act Notice, see page 7 of the instructions. Cat. No. 13086I Form **4797** (2003)

For Example 3

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2003
Attachment Sequence No. 12

Name(s) shown on Form 1040: Roger
Your social security number: 111 11 1111

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

b **Net short-term capital gain or (loss).** Combine lines 1 through ... in column (f) . 7b

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) for the entire year Subtract (e) from (d)	(g) Post-May 5 gain or (loss)* (see below)
8							
9	Enter your long-term totals, if any, from Schedule D-1, line 9	9					
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10					
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11	6,000	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12		
13	Capital gain distributions. See page D-1 of the instructions				13		
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your 2002 Capital Loss Carryover Worksheet				14	( )	
15	Combine lines 8 through 13 in column (g). If zero or less, enter -0-				15		
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) **Next:** Go to Part III on the back.				16	6,000	

*Include in column (g) all gains and losses from column (f) from sales, exchanges, or conversions (including installment payments received) **after** May 5, 2003. However, **do not** include gain attributable to unrecaptured section 1250 gain, "collectibles gains and losses" (as defined on page D-6 of the instructions) or eligible gain on qualified small business stock (see page D-4 of the instructions).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2003**

For Example 3

Schedule D (Form 1040) 2003 — Page **2**

Part III — Taxable Gain or Deductible Loss

17a	Combine lines 7b and 16 and enter the result. If a loss, enter -0- on line 17b and go to line 18. If a gain, enter the gain on Form 1040, line 13a, and go to line 17b below	17a	6,000
b	Combine lines 7a and 15. If zero or less, enter -0-. Then complete Form 1040 through line 40	17b	0
	Next: • If line 16 of Schedule D is a gain **or** you have qualified dividends on Form 1040, line 9b, complete **Part IV** below. • Otherwise, skip the rest of Schedule D and complete Form 1040.		
18	If line 17a is a loss, enter here and on Form 1040, line 13a, the **smaller** of **(a)** that loss or **(b)** ($3,000) (or, if married filing separately, ($1,500)) (see page D-6 of the instructions)	18	( )
	Next: • If you have qualified dividends on Form 1040, line 9b, complete Form 1040 through line 40, and then complete **Part IV** below (but skip lines 19 and 20). • Otherwise, skip **Part IV** below and complete the rest of Form 1040.		

Part IV — Tax Computation Using Maximum Capital Gains Rates

If line 16 or line 17a is zero or less, skip lines 19 and 20 and go to line 21. Otherwise, go to line 19.

19	Enter your unrecaptured section 1250 gain, if any, from line 18 of the worksheet on page D-6			19	6,000
20	Enter your 28% rate gain, if any, from line 7 of the worksheet on page D-9 of the instructions			20	
	If lines 19 and 20 are zero, go to line 21. Otherwise, complete the worksheet on page D-10 of the instructions to figure the amount to enter on lines 35 and 53 below, and skip all other lines below.				
21	Enter your taxable income from Form 1040, line 40			21	
22	Enter the **smaller** of line 16 or line 17a, but not less than zero	22			
23	Enter your qualified dividends from Form 1040, line 9b	23			
24	Add lines 22 and 23	24			
25	Amount from line 4g of Form 4952 (investment interest expense)	25			
26	Subtract line 25 from line 24. If zero or less, enter -0-			26	
27	Subtract line 26 from line 21. If zero or less, enter -0-			27	
28	Enter the **smaller** of line 21 **or:** • $56,800 if married filing jointly or qualifying widow(er); • $28,400 if single or married filing separately; or • $38,050 if head of household	28			
	If line 27 is more than line 28, skip lines 29–39 and go to line 40.				
29	Enter the amount from line 27	29			
30	Subtract line 29 from line 28. If zero or less, go to line 40	30			
31	Add lines 17b and 23* (line 31)				
32	Enter the **smaller** of line 30 or line 31	32			
33	Multiply line 32 by 5% (.05)			33	
	If lines 30 and 32 are the same, skip lines 34–39 and go to line 40.				
34	Subtract line 32 from line 30	34			
35	Enter your qualified 5-year gain, if any, from line 8 of the worksheet on page D-8 (line 35)				
36	Enter the **smaller** of line 34 or line 35	36			
37	Multiply line 36 by 8% (.08)			37	
38	Subtract line 36 from line 34	38			
39	Multiply line 38 by 10% (.10)			39	
	If lines 26 and 30 are the same, skip lines 40–49 and go to line 50.				
40	Enter the **smaller** of line 21 or line 26	40			
41	Enter the amount from line 30 (if line 30 is blank, enter -0-)	41			
42	Subtract line 41 from line 40	42			
43	Add lines 17b and 23* (line 43)				
44	Enter the amount from line 32 (if line 32 is blank, enter -0-) (line 44)				
45	Subtract line 44 from line 43 (line 45)				
46	Enter the **smaller** of line 42 or line 45	46			
47	Multiply line 46 by 15% (.15)			47	
48	Subtract line 46 from line 42	48			
49	Multiply line 48 by 20% (.20)			49	
50	Figure the tax on the amount on **line 27.** Use the Tax Table or Tax Rate Schedules, whichever applies			50	
51	Add lines 33, 37, 39, 47, 49, and 50			51	
52	Figure the tax on the amount on **line 21.** Use the Tax Table or Tax Rate Schedules, whichever applies			52	
53	**Tax on all taxable income.** Enter the **smaller** of line 51 or line 52 here and on Form 1040, line 41			53	17,533

*If line 25 is more than zero, see **Lines 31 and 43** on page D-9 for the amount to enter.

Schedule D (Form 1040) 2003

For Example 3

Schedule D Tax Worksheet—Line 53

Keep for Your Records

Complete this worksheet only if line 19 or line 20 of Schedule D is more than zero.

1.	Enter your taxable income from Form 1040, line 40	1. 82,000
2.	Enter your qualified dividends from Form 1040, line 9b	2. 0
3.	Enter the amount from Form 4952, line 4g	3. 0
4.	Enter the amount from Form 4952, line 4e	4. 0
5.	Subtract line 4 from line 3. If zero or less, enter -0-	5. 0
6.	Subtract line 5 from line 2. If zero or less, enter -0-	6. 0
7.	Enter the **smaller** of line 16 or line 17a of Schedule D	7. 6,000
8.	Enter the **smaller** of line 3 or line 4	8. 0
9.	Subtract line 8 from line 7. If zero or less, enter -0-	9. 6,000
10.	Add lines 6 and 9	10. 6,000
11.	Add lines 19 and 20 of Schedule D	11. 6,000
12.	Enter the **smaller** of line 9 or line 11	12. 6,000
13.	Subtract line 12 from line 10.	13. 0
14.	Subtract line 13 from line 1. If zero or less, enter -0-.	14. 82,000
15.	Enter the **smaller** of line 1 or: • $56,800 if married filing jointly or qualifying widow(er); • $28,400 if single or married filing separately; or • $38,050 if head of household.	15. 28,400
16.	Enter the **smaller** of line 14 or line 15	16. 28,400
17.	Subtract line 10 from line 1. If zero or less, enter -0-	17. 76,000
18.	Enter the **larger** of line 16 or line 17	▶ 18. 76,000
	If lines 15 and 16 are the same, skip lines 19 through 28 and go to line 29. Otherwise, go to line 19.	
19.	Subtract line 16 from line 15	▶ 19.
20.	Add the amounts on Schedule D, line 17b, and line 6 above	20.
21.	Enter the **smaller** of line 19 or line 20	21.
22.	Multiply line 21 by 5% (.05)	22.
	If lines 19 and 21 are the same, skip lines 23 through 28 and go to line 29. Otherwise, go to line 23.	
23.	Subtract line 21 from line 19	23.
24.	Qualified 5-year gain from the worksheet on page D-8. **Also enter on Schedule D, line 35**	24.
25.	Enter the **smaller** of line 23 or line 24	25.
26.	Multiply line 25 by 8% (.08)	26.
27.	Subtract line 25 from line 23	27.
28.	Multiply line 27 by 10% (.10)	28.
	If lines 1 and 15 are the same, skip lines 29 through 47 and go to line 48. Otherwise, go to line 29.	
29.	Enter the **smaller** of line 1 or line 13	29. 0
30.	Enter the amount from line 19 (if line 19 is blank, enter -0-)	30. 0
31.	Subtract line 30 from line 29. If zero or less, enter -0-	▶ 31. 0
32.	Add the amounts on Schedule D, line 17b, and line 6 above	32. 0
33.	Enter the amount from line 21 (if line 21 is blank, enter -0-)	33. 0
34.	Subtract line 33 from line 32	34. 0
35.	Enter the **smaller** of line 31 or line 34	35. 0
36.	Multiply line 35 by 15% (.15)	36. 0
37.	Subtract line 35 from line 31	37. 0
38.	Multiply line 37 by 20% (.20)	38. 0
	If Schedule D, line 19, is zero or blank, skip lines 39 through 44 and go to line 45. Otherwise, go to line 39.	
39.	Enter the **smaller** of line 9 above or Schedule D, line 19	39. 6,000
40.	Add lines 10 and 18	40. 82,000
41.	Enter the amount from line 1 above	41. 82,000
42.	Subtract line 41 from line 40. If zero or less, enter -0-	42. 0
43.	Subtract line 42 from line 39. If zero or less, enter -0-	▶ 43. 6,000
44.	Multiply line 43 by 25% (.25)	44. 1,500
	If Schedule D, line 20, is zero or blank, skip lines 45 through 47 and go to line 48. Otherwise, go to line 45.	
45.	Add lines 18, 19, 31, and 43	45.
46.	Subtract line 45 from line 1	46.
47.	Multiply line 46 by 28% (.28)	47.
48.	Figure the tax on the amount on **line 18**. Use the Tax Table or Tax Rate Schedules, whichever applies	48. 16,033
49.	Add lines 22, 26, 28, 36, 38, 44, 47, and 48	49. 17,533
50.	Figure the tax on the amount on **line 1.** Use the Tax Table or Tax Rate Schedules, whichever applies	50. 17,713
51.	**Tax on all taxable income (including capital gains and qualified dividends).** Enter the **smaller** of line 49 or line 50. Also enter this amount on Schedule D, line 53, **and** Form 1040, line 41	51. 17,533

D-10

Example 4. Jane, a self-employed consultant, sold her principal residence in 2003 and had a gain of $30,000 (considering depreciation allowed or allowable). She meets the dual ownership and use tests to exclude the gain. However, she used 10% of the home for her home office from July 1, 1997, until the date of sale on November 20, 2003. She claimed a total of $3,000 of MACRS on the home office portion on her 1997–2003 Schedules C.

2003 Tax Solution for Jane. She must report $3,000 as a taxable gain on her 2003 Form 4797. She can exclude the $27,000 balance of the gain. The $3,000 taxable gain will be unrecaptured §1250 gain and will be taxed at a maximum 25% rate on Jane's 2003 Schedule D. The reporting of the $3,000 gain will be similar to that shown in **Example 3**, assuming the 2003 Form 4797 Instructions are similar to those for 2002.

OTHER TAX CHANGES FROM TREASURY DECISION 9030

1. If the business or rental use takes place in a **separate structure** that is apart from the dwelling unit, gain must be allocated between the separate structure and the dwelling unit. The **entire gain on the sale of the separate structure**, not just the portion of the gain due to depreciation allowed after May 6, 1997, would be taxable on Form 4797.[3]

2. **Each unmarried individual who is a joint owner** of a principal residence is eligible to exclude $250,000 of the total gain attributable the sale of the home.[4]

3. Generally, **only one home** can be treated as the principal residence for a given tax year. If the taxpayer alternates between homes owned concurrently, facts and circumstances must be applied to determine which home is the principal residence. See Treas. Reg. §1.121-1(b)(2) for the six factors listed.

> **Note.** See the *Guinan* District Court case in the **Principal Residence** section of the **Rulings and Cases Chapter** for a thorough analysis of this issue.

4. A separate sale of **vacant land** can qualify for the IRC §121 exclusion if **three** conditions are met:
   - It must be **adjacent** to the land on which the principal residence is located.
   - It must be **used** as part of the principal residence.
   - The qualifying separate sale of the principal residence occurs within **two years before or after** the separate sale of the vacant land.[5]

> **Note.** Qualifying separate sales of the principal residence and adjacent land are **considered to be one sale**. Therefore, the $250,000 or $500,000 (married joint filers) maximum exclusion applies to **both** sales. If the separate sales occur in different tax years, the exclusion is applied **first** to the sale of the principal residence.

Example 5. Laura, a single taxpayer, bought a home and ten acres of land in 1991. Both the home and the acreage were used as her principal residence. In May 2005, she sells eight acres of vacant land and realizes a gain of $100,000.

In March 2007, she sells the home and the remaining two acres and realizes a gain of $200,000.

Tax Solution for Example 5.

1. Since Laura did not sell the home before the due date for filing her 2005 return, she **cannot exclude the $100,000 sale of the eight acres** on her **2005** tax return.
2. Laura **may exclude** the $200,000 gain on the sale of the home and two acres on her **2007** tax return.

3. Laura should file an **amended 2005** return (Form 1040X) and claim the remaining $50,000 IRC §121 exclusion on the sale of the eight acres. She reported a $100,000 long-term capital gain on her original 2005 return. However, the **2005 Form 1040X** will show that only $50,000 of the $100,000 gain is taxable. The other $50,000 gain is excludable under the final regulations for IRC §121.[6]

> **Note.** If Laura had used the land for business purposes or received income from the land, i.e., rent, CRP payments, she would not be entitled to exclude the gain as part of her personal residence exclusion.

ANALYSIS OF TREASURY DECISION 9031

Background Information

This Treasury Decision involves temporary regulations under IRC §121 pertaining to the **reduced (prorated) maximum exclusion** for principal residence sales due to:

- Change in Place of Employment,[7]
- Health Reasons,[8] or
- Unforeseen Circumstances.[9]

These principal residence sales may qualify for the reduced (prorated) maximum exclusion. In fact, a sale due to practically any unforeseen circumstance **will likely qualify** for the reduced exclusion.

General Rule for the Reduced (Prorated) Maximum Exclusion (Pub. 523)

You can claim an exclusion, but the maximum amount of gain you can exclude will be reduced if either of the following is true.

1. *You did not meet the dual ownership and use tests, but the primary reason (explained later) you sold the home was:*
   - *A change in place of employment,*
   - *Health, or*
   - *Unforeseen circumstances, to the extent provided in regulations.*
2. *Your exclusion would have been disallowed because you sold another home at a gain during the 2-year period ending on the date of the sale of the current home and excluded all or part of the gain. However, the primary reason you sold the current home was due to:*
   - *A change in place of employment,*
   - *Health, or*
   - *Unforeseen circumstances, to the extent provided in regulations.*

Worksheet 3 (from IRS Pub. 523) that can be used to compute the **Reduced Maximum Exclusion** is shown.

For Example 5

Worksheet 3. **Reduced Maximum Exclusion**

Caution: *Complete this worksheet only if you qualify for a reduced maximum exclusion. (See* Reduced Maximum Exclusion *earlier.) Complete column (B) only if you are married filing a joint return.*

			(A) You	(B) Your Spouse
1.	Maximum amount	**1.**	$250,000.00	$250,000.00
2a.	Enter the number of days (or months) that you used the property as a main home during the 5-year period ending on the date of sale. (If married filing jointly, fill in columns (A) and (B))	**2a.**		
b.	Enter the number of days (or months) that you owned the property during the 5-year period ending on the date of sale. (If married filing jointly and one spouse owned the property longer than the other spouse, both spouses are treated as owning the property for the longer period)	**b.**		
c.	Enter the smaller of line 2a or 2b	**c.**		
3.	Have you (or your spouse if filing jointly) excluded gain from the sale of another home during the 2-year period ending on the date of this sale? **NO.** Skip line 3 and enter the number of days (or months) from line 2c on line 4. **YES.** Enter the number of days (or months) between the date of the most recent sale of another home on which you excluded gain and the date of sale of this home	**3.**		
4.	Enter the smaller of line 2c or 3	**4.**		
5.	Divide the amount on line 4 by 730 days (or 24 months). Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.000	**5.**		
6.	Multiply the amount on line 1 by the decimal amount on line 5	**6.**		
7.	Add the amounts in columns (A) and (B) of line 6. This is your **reduced maximum exclusion**. Enter it here and on *Worksheet 2*, line 8	**7.**		

Primary Reason Defined

There are certain sets of facts and circumstances **(safe harbors)**, described later, that will be treated as satisfying the **primary reason test** for the sale of a principal residence. If the home sale does **not** qualify under one of the safe harbors, **it still may qualify** for the reduced maximum exclusion based on the following six listed factors:[10]

1. The taxpayer's **financial ability** to maintain the home materially changes.
2. The **suitability** of the home as the taxpayer's principal residence changes.
3. The circumstances causing the sale of the home **were not reasonably foreseeable** when the taxpayer began to use the home as a principal residence.
4. The taxpayer uses the home as a principal residence during the ownership period.
5. Circumstances which cause the sale occur during the period the taxpayer owns and uses the home as a principal residence.
6. The sale and the circumstances which cause the sale are close in time.

Note. See **Example 8** for a situation in which the application of these six factors **may** result in the sale qualifying for the reduced maximum exclusion. These six factors are often referred to as "the facts and circumstances test."

Change in Place of Employment Safe Harbor

This safe harbor will be met if the **primary reason** for the sale is because a **qualified individual** (defined on the following page) has a change in the location of employment.

Qualified Individual Defined. For purposes of the reduced maximum exclusion, a qualified individual is any of the following:

- The taxpayer
- The taxpayer's spouse
- A co-owner of the residence
- A person whose principal place of abode is in the same household as the taxpayer

Employment Defined. For this safe harbor, employment includes the start of work with a new employer or continuation of work with the same employer. It also includes the start or continuation of self-employment.

Distance Safe Harbor (for Change in Place of Employment Safe Harbor). The primary reason for the sale of a taxpayer's principal residence meets the Change in Place of Employment Safe Harbor if:

1. The change occurs during the period the taxpayer owns and uses the home as a principal residence, and
2. The new place of employment **is at least 50 miles farther** from the home sold than was the former place of employment.

Example 6 (for the Change in Place of Employment Safe Harbor). Sally and her partner, Fred, both work for separate employers in Decatur. They are co-owners of their Decatur principal residence which they bought in June 2002. In March 2003, Fred's employer changed his place of employment to Oak Park (a distance of 170 miles from Decatur). Sally and Fred sold their jointly owned Decatur home in July 2003 and realized a gain of $15,000.

Tax Solution for Example 6. The sale of the Decatur home qualifies for the change in place of employment safe harbor. As a result, the entire $15,000 gain is excludable using the reduced maximum exclusion.

Health Safe Harbor

This safe harbor will be met if the **primary reason** for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of diseases, illness, or injury of a **qualified individual** (defined as follows).

Qualified Individual Defined. For purposes of the reduced maximum exclusion, a qualified individual includes the four individuals shown previously for the Change in Place of Employment safe harbor plus the following individuals:

- Parent, grandparent, stepmother, stepfather
- Child, grandchild, stepchild, adopted child
- Brother, sister, stepbrother, stepsister, half brother, half sister
- Mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, or daughter-in-law
- Uncle, aunt, nephew, or niece

Example 7 (For the Health Safe Harbor). On March 1, 2002, Luis and Maria, a married couple with U.S. citizenship, bought their first principal residence in Chicago, IL. On February 1, 2003, they sold the home and moved to Mexico City to care for Maria's father, who was diagnosed with cancer. Their gain on the sale was $20,000.

Tax Solution for Example 7. They are entitled to the reduced maximum exclusion on their 2003 joint return. As a result, all of their $20,000 gain is excludable. Their reduced maximum exclusion is $((337 \div 730) \times \$500,000)$ or $230,822.

Unforeseen Circumstances Safe Harbor

This safe harbor will be met if the **primary reason** for the sale is because of **an event that the taxpayer did not anticipate** before purchasing and occupying the home.[11] **Seven specific safe harbors** are:

1. Involuntary conversion of the home,
2. Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the home,

> **Note.** For safe harbors numbers 3 through 7, a **qualified individual** is the same as defined for the Change in Place of Employment Safe Harbor.

3. Death,
4. Unemployment, provided the qualified individual is **eligible for unemployment compensation,**
5. Change in employment of a qualified individual that causes the taxpayer to be unable to pay reasonable basic living expenses for the taxpayer's household,
6. Divorce or legal separation, or
7. Multiple births resulting from the same pregnancy of any qualified individual.

Example 8 (For the Unforeseen Circumstances Safe Harbor). Senator Edward Kennedy and his wife bought an expensive home in a gated community in Boston, MA, in April 2002 for $750,000. He and his wife used it as their principal residence. In July 2003, Rush Limbaugh and his wife bought a home across the street from the Kennedy residence. Senator Kennedy was incensed and told the press, "I refuse to live on the same street with Mr. Limbaugh." Senator Kennedy and his wife sold their home in September 2003 and realized a $90,000 gain.

Tax Solution for Example 8. The $90,000 gain **may or may not** be excludable using the reduced maximum exclusion. The key is whether the primary reason the house was sold was due to an **unforeseen circumstance** caused by an event that the taxpayers **did not anticipate** before they bought and occupied the home.

> **Note.** It is the opinion of the author that the IRS is not likely to accept this within the scope of Treasury Decision 9031.

> **Planning Pointer.** The taxpayer-friendly wording of Treasury Decision 9031 provides taxpayers and their tax preparers significant latitude in deciding whether a particular home sale qualifies for the reduced (prorated) exclusion. As noted earlier, amended returns for all open years are an available option.

PROBLEM 3: ADOPTION CREDIT

CHANGES FOR 2003

Several tax law changes affect the computation of the Adoption Credit on the 2003 Form 8839. The **2003 changes** are:

1. For tax years beginning in 2003, the maximum credit per child increases to $10,160.

> **Note.** The $10,000 maximum credit amount for 2002 is indexed for inflation in tax years 2003 through 2010.

2. The credit **begins to phase out** under IRC §23(b)(2)(A) for taxpayers with 2003 modified AGI **in excess of $152,390**. The credit is **completely phased out** for taxpayers with 2003 modified AGI of **$192,390** or more. These phaseout rules apply to **all taxpayers** regardless of filing status.

3. For 2003, a **$10,160 credit** will be allowed for the adoption of a **Special Needs Child** regardless of whether the taxpayer incurs any adoption expenses.

Example 9. Jim and Mary, residents of Illinois, adopt a 4-year old child with attention deficit disorder in 2003. The Illinois Department of Children and Family Services (DCFS) determined that the child meets the state's definition of a special needs child. Jim and Mary paid only $300 in 2003 qualified adoption expenses consisting of travel expenses. All other adoption expenses were furnished by DCFS.

Their modified 2003 AGI is $110,000 and their 2003 income tax liability before any credits is $18,000.

Tax Solution for Example 9. Jim and Mary are **deemed to have paid $10,160** of qualified adoption expenses in 2003. That is the figure they will enter on line 5 on their 2003 Form 8839 for total **qualified adoption expenses**. Since their 2003 modified AGI of $110,000 is below the $152,390 phaseout floor, **they will be entitled to claim the entire maximum $10,160 adoption credit** against their $18,000 income tax amount.

4. IRS Notice 2003-15, issued on February 10, 2003, establishes safe harbors for **determining when the adoption of a foreign-born child is considered final.**

ANALYSIS FOR ADOPTION EXPENSES OF FOREIGN-BORN CHILDREN

The adoption credit for a child who is not a citizen or resident of the United States when adoption procedures begin is allowed **only**:

- In the tax year the adoption becomes **final**, or
- In a **later tax year** if any qualified adoption expenses are paid **after the year the adoption becomes final.**[12]

Because the law was unclear concerning when such adoptions became final, IRS issued Notice 2003-15. It establishes safe harbors for determining the finality of adoptions. However, these safe harbors apply only to foreign-born children who receive an **"immediate relative" (IR)** visa from the State Department. These **IR visas** are issued only to foreign-born children who enter the United States after a foreign government (court or agency) has approved either an adoption or a guardianship decree.

The following chart shows the type of IR visas and when the adoptive parents can treat the adoption as final for purposes of the adoption credit.

Type of IR Visa Granted to Child	Tax Year the Adoption Is Considered Final
IR-3	Year in which the foreign government enters an adoption decree
IR-4 (for guardianship or legal custody arrangements)	Year in which a court of the home state of the adoptive parent(s) enters an adoption decree
IR-2	Year in which a court of the home state of the adoptive parent(s) enters a decree of "readoption" or otherwise recognizes the adoption decree of the foreign government

Example 10. Ted and Lilly Adams went to China in November 2002 to begin the adoption process for a 1-year-old Chinese female baby. They returned to China in late October 2003 after the Chinese authorities had completed the legal adoption procedures. Ted and Lilly and their Chinese baby, whom they named Christa, returned to Nebraska in December 2003. The State Department issued an IR-3 visa to Christa. A county court in Nebraska entered a readoption decree for Christa in March 2004.

Ted and Lilly paid the following qualifying adoption expenses:

Year	Expenses Paid
2002	$3,500
2003	6,000
2004	500

Question A. When is Christa's adoption considered final under §23(a)(2)?

Answer A. In 2003, the tax year the Chinese governmental authorities entered an adoption decree.

Question B. In which tax years can Ted and Lilly claim the adoption credit on **Form 8839?**

Answer B. In **2003**, the year the adoption became final, they can claim the credit for $9,500 of expenses paid in 2002 and 2003. In **2004**, they can claim the credit for the $500 of expenses paid in 2004. See the completed 2003 Form 8839 for Ted and Lilly for **Example 10** and Questions and Answers A and B. Their 2004 Form 8839 is not shown.

Note. The phaseout applies as their 2003 modified AGI is more than $152,390.

Question C. Assume the same facts as in **Example 10,** except the State Department issued an **IR-4 visa** to Christa instead of an IR-3 visa. In addition, the Nebraska county court entered an adoption decree in March 2004. In this scenario, in which tax year would Ted and Lilly be entitled to claim the adoption credit on Form 8839?

Answer C. In **2004**, when the adoption is considered final.

When to Take the Adoption Credit for a Child Who Is Not a U.S. Citizen or Resident, from IRS Pub. 968, *Tax Benefits for Adoption* (For Use in Preparing 2002 Returns)

IF you pay qualifying expenses in...	THEN take the credit in...
any year before the year the adoption becomes final	the year that the adoption becomes final.
the year the adoption becomes final	the year the adoption becomes final.
any year after the year the adoption becomes final	the year of the payment.

For Example 10

Form **8839**

Department of the Treasury
Internal Revenue Service

Qualified Adoption Expenses

▶ Attach to Form 1040 or 1040A.

▶ See separate instructions.

OMB No. 1545-1552

2003

Attachment Sequence No. 38

Name(s) shown on return: **Ted and Lilly**

Your social security number: **333 33 3333**

Before you begin: You need to understand the following terms. See **Definitions** in the instructions.

- **Eligible Child**
- **Employer-Provided Adoption Benefits**
- **Qualified Adoption Expenses**

Part I **Information About Your Eligible Child or Children—**You **must** complete this part. See the instructions for details, including what to do if you need more space.

1	(a) Child's name First	(a) Child's name Last	(b) Child's year of birth	Check if child was— (c) born **before** **1984** and was disabled	(d) a child with special needs	(e) a foreign child	(f) Child's identifying number
Child 1	Christa	Adams	2001	☐	☐	☑	888 88 8888
Child 2				☐	☐	☐	

Draft

Caution: *If the child was a foreign child, see* ***Special Rules*** *in the instructions for line 1, column (e), before you complete Part II or Part III. If you received* ***employer-provided adoption benefits,*** *complete Part III on the back next.*

Part II **Adoption Credit**

Before you begin: If you are filing Form 1040 and are claiming the mortgage interest credit (see the instructions for Form 1040, line 52), first complete **Form 8396.**

			Child 1	Child 2		
2	Maximum credit per child	2	$10,160 00	$10,160 00		
3	Did you file Form 8839 for a prior year? ☑ **No.** Enter -0-. ☐ **Yes.** See the instructions for the amount to enter.	3	0			
4	Subtract line 3 from line 2	4	10,160			
5	Enter your total **qualified adoption expenses** (see instructions).	5	9,500			
	Caution: *Your qualified adoption expenses may not be equal to the adoption expenses you paid in 2003.*					
6	Enter the **smaller** of line 4 or line 5	6	9,500			
7	Add the amounts on line 6. If zero, skip lines 8-11 and enter -0- on line 12				7	9,500
8	Enter your modified adjusted gross income (see instructions)			8	170,000	
9	Is line 8 more than $152,390? ☐ **No.** Skip lines 9 and 10, and enter -0- on line 11. ☑ **Yes.** Subtract $152,390 from line 8			9	17,610	
10	Divide line 9 by $40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000"				10	× .440
11	Multiply line 7 by line 10				11	4,180
12	Subtract line 11 from line 7				12	5,320
13	Carryforward of adoption credit from prior years (see instructions)				13	0
14	Add lines 12 and 13				14	5,320
15	**1040 filers:** Enter the amount from Form 1040, line 43. **1040A filers:** Enter the amount from Form 1040A, line 28.			15	32,260	
16	**1040 filers:** Add the amounts from Form 1040, lines 44 through 49, and any mortgage interest credit from Form 8396, line 11, and enter the total. **1040A filers:** Add the amounts from Form 1040A, lines 29 through 33, and enter the total.			16	0	
17	Subtract line 16 from line 15				17	32,260
18	**Adoption credit.** Enter the smaller of line 14 or line 17 here and on Form 1040, line 50, or Form 1040A, line 34. If line 17 is smaller than line 14, you may have a credit carryforward (see instructions)				18	5,320

For Paperwork Reduction Act Notice, see page 5 of instructions. Cat. No. 22843L Form **8839** (2003)

PROBLEM 4: ALTERNATIVE MINIMUM TAX (AMT) FOR INDIVIDUAL TAXPAYERS

BACKGROUND INFORMATION

It is difficult for most taxpayers and tax preparers to engage in effective planning to minimize individual AMT liability. The reason is that almost all tax planning is carried out with the goal of reducing the **regular** tax liability. The accomplishment of that goal produces an even greater likelihood that the individual taxpayer will owe AMT.

The latest Statistics of Income Bulletin as reported in IRS News Release IR-2003-53 (April 2003) showed that, **contrary to the trend** for tax years 1997 through 2000, total AMT liability on **2001** individual tax returns **actually fell 32.5% to $6 billion.** In contrast, total AMT liability reported on **2000** individual returns was **$9.6 billion.**

As the economy recovers, AMT is expected to impact an increasing number of middle-class taxpayers, particularly those with AGIs between $50,000 and $100,000. The main causes for this expected explosion in future AMT liability are:

- The EGTRR Act of 2001, the JCWA of 2002 and the Jobs and Growth Tax Relief Reconciliation (JGTRR) Act of 2003 reduced regular income tax liabilities for individuals.
- Except for **temporary** increases in the individual AMT exemption amount for the tax years 2001 through 2004, the AMT exemption amount has remained unchanged. In addition, the AMT exemption amount, unlike regular tax brackets, personal exemptions, and other items, is **not indexed** for inflation.

  The increased AMT exemption amounts for 2003 and 2004 are shown in the chart:

Filing Status	AMT Exemption Amount
Single & Head of Household	$40,250
Married Filing Joint & Qualifying Widow(er)	58,000
Married Filing Separate	29,000

  According to the Congressional Joint Committee on Taxation, 11.3 million taxpayers will owe AMT beginning in 2005.

- The AMT exemption amount is **phased out** for high income taxpayers. In addition, the AGI levels that produce the phaseout are **not indexed** for inflation.
- The individual AMT tax rates of 26% and 28% on alternative minimum taxable income (AMTI) are often higher than a taxpayer's regular income tax rates. The likelihood of this is now greater with the passage of the JGTRR Act of 2003.

TYPICAL REGULAR TAX DEDUCTIONS AND INCOME THAT CAN LIKELY PRODUCE AMT LIABILITY

1. **Personal Exemptions.** They are allowed for regular tax purposes but not for AMT purposes. Taxpayers with several children and a small regular taxable income may be liable for AMT although they have no AMT adjustment or preference items.

> **Note.** See page 506 in the *1999 University of Illinois Farm Income Tax Workbook* for a thorough analysis of the *Klaassen* court case decision [10th Cir. Ct. of Appeals, 99-1 USTC ¶50,418].

2. **Standard Deduction.** A taxpayer who claims the standard deduction for regular tax purposes is not allowed to deduct it for AMT purposes.

Note. See page 364 in the *2001 University of Illinois Farm Income Tax Workbook* for Letter Ruling 200103073 which provides more information on this topic.

3. **State and Local Property Taxes and Income Taxes.** Taxpayers who itemize and reside in states with high local property and high state income taxes might owe AMT. These itemized deductions from line 9, Schedule A, are not allowed in computing AMT on Form 6251. This **adjustment** in computing AMTI is made on line 3, Form 6251.

Note. See pages 327–328 in the *2001 University of Illinois Farm Income Tax Workbook* for an example of this AMT adjustment.

4. **Interest Paid on Home Equity Loans** if the loan proceeds were not used to buy, build, or substantially improve either a taxpayer's principal residence or a second home. Many taxpayers use home equity loans to pay for various purposes, for example, to pay for:

   - college expenses of their children,
   - weddings,
   - vacations, or
   - federal and state income taxes.

   The deduction claimed on these home equity loans on lines 10, 11, or 12 of Schedule A must be shown as an **adjustment** in computing AMTI on line 4, Form 6251. This interest is not deductible for AMT purposes. This AMT adjustment, which can be substantial, is often overlooked or forgotten by preparers.

5. **All or a portion of the Medical Expenses Deduction claimed on line 4, Schedule A.** Taxpayers who claim large medical deductions are more likely to owe AMT. For AMT purposes, only those unreimbursed medical expenses which exceed **10%** of AGI are deductible instead of the **7.5%** limitation that applies to Schedule A. Therefore, taxpayers with large medical expenses must show 2.5% of their AGI as an **adjustment** in computing AMTI on line 2, Form 6251.

Example 11. Homer, a 90-year-old resident of a nursing home, reported the following on his **2003** return:

AGI	$125,000
Unreimbursed medical expenses from line 1, Schedule A	53,000
7.5% limitation from line 3, Schedule A ($125,000 × 7.5%)	(9,375)
Medical deduction from line 4, Schedule A	43,625

Tax Solution for Example 11. On line 2 of his **2003** Form 6251, Homer must show **$3,125** (2.5% of his $125,000 AGI) as an **adjustment** in computing AMTI. Since Homer's taxable income is relatively low, he may owe AMT, especially if he has other AMT adjustment or preference items.

For Informational Purposes

Form **6251** — Department of the Treasury, Internal Revenue Service (99)

Alternative Minimum Tax— Individuals

► See separate instructions.

► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227 — **2003** — Attachment Sequence No. **32**

Name(s) shown on Form 1040 | Your social security number

Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 38, and go to line 2. Otherwise, enter the amount from Form 1040, line 35, and go to line 7. (If zero or less, enter as a negative amount.)	1	
2	Medical and dental. Enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2½% of Form 1040, line 35	2	
3	Taxes from Schedule A (Form 1040), line 9	3	
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	
5	Miscellaneous deductions from Schedule A (Form 1040), line 26	5	
6	If Form 1040, line 35, is over $139,500 (over $69,750 if married filing separately), enter the amount from line 9 of the worksheet for Schedule A (Form 1040), line 28	6	( )
7	Tax refund from Form 1040, line 10 or line 21	7	( )
8	Investment interest expense (difference between regular tax and AMT)	8	
9	Depletion (difference between regular tax and AMT)	9	
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10	
11	Interest from specified private activity bonds exempt from the regular tax	11	
12	Qualified small business stock (see instructions)	12	
13	Exercise of incentive stock options (excess of AMT income over regular tax income)	13	
14	Estates and trusts (amount from Schedule K-1 (Form 1041), line 9)	14	
15	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15	
16	Disposition of property (difference between AMT and regular tax gain or loss)	16	
17	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	17	
18	Passive activities (difference between AMT and regular tax income or loss)	18	
19	Loss limitations (difference between AMT and regular tax income or loss)	19	
20	Circulation costs (difference between regular tax and AMT)	20	
21	Long-term contracts (difference between AMT and regular tax income)	21	
22	Mining costs (difference between regular tax and AMT)	22	
23	Research and experimental costs (difference between regular tax and AMT)	23	
24	Income from certain installment sales before January 1, 1987	24	( )
25	Intangible drilling costs preference	25	
26	Other adjustments, including income-based related adjustments	26	
27	Alternative tax net operating loss deduction	27	( )
28	**Alternative minimum taxable income.** Combine lines 1 through 27. (If married filing separately and line 28 is more than $173,000, see page 7 of the instructions.)	28	

Part II Alternative Minimum Tax

29 Exemption. (If this form is for a child under age 14, see page 7 of the instructions.)

IF your filing status is . . .	AND line 28 is not over . . .	THEN enter on line 29 . . .
Single or head of household	$112,500	$40,250
Married filing jointly or qualifying widow(er)	150,000	58,000
Married filing separately	75,000	29,000

If line 28 is **over** the amount shown above for your filing status, see page 7 of the instructions. — **29**

30	Subtract line 29 from line 28. If zero or less, enter -0- here and on lines 33 and 35 and stop here	30	
31	• If you reported capital gain distributions directly on Form 1040, line 13a; you reported qualified dividends on Form 1040, line 9b; **or** you had a gain on both lines 16 and 17a of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 65 here. • **All others:** If line 30 is $175,000 or less ($87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result.	31	
32	Alternative minimum tax foreign tax credit (see page 7 of the instructions)	32	
33	Tentative minimum tax. Subtract line 32 from line 31	33	
34	Tax from Form 1040, line 41 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 44)	34	
35	**Alternative minimum tax.** Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 42	35	

For Paperwork Reduction Act Notice, see page 8 of the instructions. Cat. No. 13600G Form **6251** (2003)

6. **Miscellaneous Itemized Deductions, including unreimbursed employee business expenses, claimed on line 26, Schedule A.** This is a fairly common cause for AMT liability, since these expenses must be shown as an **adjustment** in computing AMTI on line 5, Form 6251. They are not deductible for AMT purposes. Outside salespersons, including manufacturers' representatives, are often liable for AMT on Form 6251.

Note. See pages 506–507 in the *1999 University of Illinois Farm Income Tax Workbook* and pages 328–329 in the *2001 University of Illinois Farm Income Tax Workbook* for more information on this issue.

Another situation that is likely to cause AMT liability is legal fees paid by an employee or former employee and deducted as a miscellaneous itemized deduction. This AMT issue is often present for many taxpayers who pay **contingent attorney fees** for successful sexual harassment, age, gender, or racial discrimination lawsuits against their former employers. There are numerous court cases involving this issue. The most common tax result in these court cases was that the taxpayers were liable for significant AMT liability.

Note. See pages 296–297 in the *2002 University of Illinois Income Tax Workbook* for a thorough analysis of the *Moore* court case decision.[13]

7. **Incentive Stock Options (ISOs).** This additional compensation income is afforded favorable (deferred) regular tax treatment until the stock acquired by the exercise of the ISO is sold. However, under AMT rules, the difference between the market price and the exercise grant price actually paid for the stock must be recognized in computing AMTI. This **adjustment** is shown on line 13, Form 6251. Although ISOs are not as prevalent in 2003 as they were in the late 1990s, the exercise of an ISO can and often does trigger AMT liability.

Example 12. Michelle exercised an ISO granted to her by her employer in **March 2003**. Following are the details relating to her exercise of the ISO:

Number of shares	1,000
Exercise grant price per share	$ 30
Market value price per share at time of exercise	100
Untaxed (for regular tax) "spread" amount per share	70
Untaxed (for regular tax) total amount (1,000 shares × $70)	$70,000
Date Michelle sells the 1,000 shares	July 2004

Tax Solution for Example 12. Michelle must report $70,000 as an **adjustment** on line 13 on her **2003** Form 6251. This will likely cause Michelle to owe AMT for 2003.

If she owes AMT for **2003**, she may be entitled to a minimum tax credit on her **2004** or subsequent tax returns. The reason for this is that the $70,000 adjustment on her 2003 Form 6251 is a **deferral adjustment** as opposed to an exclusion adjustment. She must prepare a **2004** Form 8801, Credit for Prior Year Minimum Tax, in order to claim the credit. Michelle's **AMT basis** in the 1,000 shares she acquired by exercising her ISO is **$100,000** rather than $30,000, which is her regular tax basis.

> **Note.**
> - See pages 500–503 in the *2000 University of Illinois Farm Income Tax Workbook* for thorough coverage of the exercise of ISOs, including planning suggestions to avoid or reduce AMT liability in the year of exercise.
> - See pages 522–524 in the *2000 University of Illinois Farm Income Tax Workbook* for thorough coverage of the minimum tax credit on Form 8801.

8. **Long-Term Capital Gains.** This type of income is not a specific adjustment or preference item for AMT on Form 6251. However, high-income taxpayers with large long-term capital gains may owe AMT. The reason for this is that the **AMT exemption amount**, which is deducted on line 29, Form 6251, may be reduced or eliminated.

Example 13. Sam, who is single, has **$110,000** of AMTI in **2003 before considering a $165,000 long-term capital gain** on the sale of vacant land in July 2003. Without considering the capital gain, Sam would normally owe no AMT in 2003 since **his $40,250 AMT exemption** amount will be sufficient to offset any AMT owed on his $110,000 AMTI.

However, after including the $165,000 long-term capital gain on the apartment building, **Sam's 2003 AMTI is $275,000**. Since that **exceeds the $273,500 phaseout ceiling** for single taxpayers, Sam is entitled to no AMT exemption on line 29 on his 2003 Form 6251.

Tax Solution for Example 13. The 15% tax rate that applies to Sam's regular tax computation on the $165,000 long-term capital gain also applies for AMT purposes. That is accomplished in Part III on page 2 of Form 6251 (not shown). Therefore, Sam's tax on the capital gain is $24,750 ($165,000 × 15%) **for both regular and AMT purposes**. However, Sam loses his $40,250 AMT exemption due to the $165,000 of long-term capital gain.

In effect, the actual AMT tax computation on the $165,000 capital gain is $35,215. The difference of **$10,465** ($35,215 – $24,750) equals Sam's lost AMT exemption amount of $40,250 times his 26% AMT tax rate ($40,250 × 26% = $10,465). This is an oversimplification of the complex AMT rules and computations.

> **Note.** The only planning suggestion for Sam to mitigate his potential 2003 AMT liability is consideration of an installment sale of the land. See Chapter 15, Rulings and Cases, for the *Marx* case in the AMT section.

PROBLEM 5: LOSSES ON INVESTMENT/RETIREMENT CONTRACTS

BACKGROUND INFORMATION

Due to the prolonged stock market and general economic decline, some taxpayers have liquidated various types of investments and retirement plans. In some cases, taxpayers were fearful of losing even more of the principal amount they invested. In other cases, including those who lost their jobs, liquidations were reluctantly made in order to pay for family living expenses. The tax ramifications of some of the most common types of liquidations are discussed next.

LOSSES IN LIQUIDATING ROTH IRAs

Losses in liquidating Roth IRAs can be deducted, but only if **all** Roth IRAs a taxpayer owns are liquidated. The amount of the loss is equal to the total amount of Roth IRA contributions less the total distributions. The loss is deducted as a miscellaneous itemized deduction subject to the 2% AGI limitation.[14]

Example 14. Leon made four annual $2,000 contributions to his only Roth IRA for the years 1998 through 2001.

In March 2003, Leon liquidated the Roth IRA and received a total distribution of **$2,000**. He will receive a 2003 Form 1099-R which reports the total $2,000 distribution in Box 1 (Gross distribution). Box 2a on the 2003 Form 1099-R (Taxable amount) will be blank.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code **Ultimate Technology Fund**	1 Gross distribution $ **2000.00** 2a Taxable amount $	OMB No. 1545-0119 **2003** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
	2b Taxable amount not determined ☒	Total distribution ☒	**Copy B**
PAYER'S Federal identification number **37-9999999** / RECIPIENT'S identification number **777-77-7777**	3 Capital gain (included in box 2a) $	**4 Federal income tax withheld** $	**Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name **Leon**	5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.)	7 Distribution code(s) **Q** / IRA/SEP/SIMPLE ☐	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code	9a Your percentage of total distribution %	9b Total employee contributions $	
Account number (optional) **13B-4032**	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
	13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form **1099-R** Department of the Treasury - Internal Revenue Service

Note. Code Q in Box 7, Distribution code, indicates that the Roth IRA distribution is a **qualified distribution** as Leon met the 5-year holding period and was at least $59^1/_2$ years of age.

Tax Solution for Example 14. Leon's loss on his total distribution from his Roth IRA is $6,000. The loss is deducted on his 2003 Schedule A as shown.

For Example 14

SCHEDULES A&B (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Schedule A— Itemized Deductions
(Schedule B is on back)
▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
2003
Attachment Sequence No. **07**

Name(s) shown on Form 1040: **Leon**
Your social security number: **777 77 7777**

Caution. Do not include expenses reimbursed or paid by others.

Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19	
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. You **must** attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶	20			
	21	Tax preparation fees	21	500		
(See page A-5 for expenses to deduct here.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶ **Loss on total distribution from sole Roth IRA ($6,000)**	22	6,000		
	23	Add lines 20 through 22	23	6,500		
	24	Enter amount from Form 1040, line 35 [24] 100,000				
	25	Multiply line 24 by 2% (.02)	25	2,000		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26	4,500
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶			27	
Total Itemized Deductions	28	Is Form 1040, line 35, over $139,500 (over $69,750 if married filing separately)? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 37. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ▶			28	

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2003**

Observations regarding **Example 14:**

1. Unlike a sale of stock or a non–retirement plan mutual fund, Leon's loss is not limited by the $3,000 capital loss limitation rules that apply to Schedule D transactions.

2. If Leon's total 2003 itemized deductions on Schedule A don't exceed the $4,750 standard deduction amount (single), he will not benefit from the Roth IRA loss.

3. The 2% AGI limitation reduced Leon's allowable miscellaneous itemized deductions by $2,000. If Leon is in the 28% tax bracket, he loses $560 of tax benefit due to the limitation.

4. If Leon is subject to AMT in 2003, the $4,500 of allowable miscellaneous itemized deductions (line 26, Schedule A) are not allowed in computing AMTI. The $4,500 will be shown as an adjustment on line 5 on Leon's 2003 Form 6251.

5. Whether Leon made a wise decision in liquidating his Roth IRA depends on many factors, including a potential recovery in the stock market.

6. The same tax rules as shown in **Example 14** would also apply to a taxpayer's losses in the complete liquidation of the following investments:

   - Nondeductible contributions to traditional IRA(s), or

   - **Commercial annuities** purchased directly from the issuer by an individual investor.[15] See **Example 15.**

Example 15. Debra, the annuitant, bought a variable annuity containing a refund feature from Last Chance Insurance Company in December 1999. She paid $50,000 for it and her funds were invested in small cap stocks. She became so disillusioned by the investment performance of the annuity that she liquidated it in March 2003. She received a total distribution of $35,000 and did not pay any surrender charge for early cancellation of the contract. The 2003 Form 1099-R that she will receive from the insurance company is shown.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code **Last Chance Insurance Co.**	1 Gross distribution $ 35000.00	OMB No. 1545-0119 2003 Form 1099-R		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
	2a Taxable amount $ 0			
	2b Taxable amount not determined ☐	Total distribution ☒		Copy B Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.
PAYER'S Federal identification number 40-1111111 · RECIPIENT'S identification number 222-22-2222	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $		
RECIPIENT'S name **Debra**	5 Employee contributions or insurance premiums $ 50000.00	6 Net unrealized appreciation in employer's securities $		
Street address (including apt. no.)	7 Distribution code(s) · IRA/SEP/SIMPLE ☐	8 Other $ %		This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code	9a Your percentage of total distribution %	9b Total employee contributions $		
Account number (optional) 362-14-P7	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $	
	13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $	

Form 1099-R Department of the Treasury - Internal Revenue Service

Tax Solution for Example 15. Debra's $15,000 loss on the liquidation of her commercial annuity is deducted as a miscellaneous itemized deduction subject to the 2% AGI limitation. Her 2003 Schedule A will be prepared in a similar manner to Leon's in **Example 14**.

Observations regarding **Example 15.**

1. The tax solution for **Example 15** assumes that Debra's variable annuity contains a **refund feature** which guarantees a partial or complete return of investment either to Debra, the annuitant, or to her beneficiary.

2. The authority for the tax solution shown for **Example 15** is IRS Pub. 575, *Pension and Annuity Income* (for use in preparing 2002 returns). Following is an excerpt from IRS Pub. 575.

   The rules in this publication apply to commercial variable annuity contracts, whether bought by an employee retirement plan for its participants, or bought directly from the issuer by an individual investor.

   Losses. You may be able to claim a loss on your return if you receive a lump-sum distribution that is less than the plan participant's cost. You must receive the distribution entirely in cash or worthless securities. The amount you can claim is the difference between the participant's cost and the amount of the cash distribution, if any.

To claim the loss, you must itemize deductions on Schedule A (Form 1040). Show the loss as a miscellaneous deduction subject to the 2%-of-adjusted-gross-income limit.

The tax solution for **Example 15** is the conservative and generally accepted manner of reporting Debra's loss. It represents the IRS point of view on the issue.

3. Some tax experts think there is substantial authority to deduct Debra's $15,000 loss as an ordinary loss in Part II on the 2003 Form 4797. The alleged authority for this position is a revenue ruling and a court case.
   - Rev. Rul. 61-201
   - *Cohan v. Commissioner*, 11 BTA 743 (1928)
4. It is the opinion of the chapter author that a close scrutiny of Rev. Rul. 61-201 and the *Cohan* court case does not lead to a conclusion that Debra's $15,000 loss is deductible in Part II, Form 4797.
5. If Debra paid a surrender charge of $3,000, resulting in a total distribution of $32,000, **her tax loss**, subject to the 2% AGI limitation, **is still $15,000**. Any surrender charges paid to liquidate a commercial annuity contract with a refund feature are not deductible. The apparent reason for this is that any surrender charges paid are not considered a part of the cost of (investment in) the annuity contract.
6. Even if Debra is under age 59$^1/_2$ when she receives the total distribution in 2003, she is not liable for the 10% early withdrawal penalty since the penalty applies only to gains.

LOSSES ON SURRENDER OF LIFE INSURANCE POLICIES

A loss on the surrender of a life insurance policy when the premiums paid exceed the cash surrender value **is not deductible.** The difference is considered to be the cost of the insurance coverage provided which is a personal nondeductible expense.

PROBLEM 6: TIMESHARES TAX ISSUES[16]

BACKGROUND INFORMATION

Many taxpayers buy timeshares to realize their vacation home dreams. More than 2.5 million American households have an ownership interest in timeshare properties. The majority of timeshares sold use the **deeded (fee simple)** type of ownership. The discussion that follows assumes this type of ownership.

Much of the applicable timeshare tax law is governed by the **vacation home limitations** of §280A. This complex code section limits the otherwise deductible expenses incurred in connection with the rental of a vacation home. More information on §280A is shown under the headings **Timeshares Rented Exclusively and Not Used Personally** and **Timeshares Used For Dual Purposes (Personal Use and Rental Use)**.

TIMESHARES USED ONLY FOR PERSONAL PURPOSES

Example 16. Dustin and Melinda Baker bought a timeshare unit in Snowmass, UT, in 2001 for $40,000. It allows them to use the unit during the last week in February. They financed $30,000 of the purchase price through the developer. In 2003, they used the property only for personal use and did not rent it.

They paid the following in 2003 (not an all inclusive list) for their timeshare property:

Annual maintenance fee	$1,900
Interest on developer-furnished mortgage loan (7% interest rate)	1,600
Local property taxes (not included in the maintenance fee figure)	180

Tax Solution for Example 16. The Bakers can deduct the $180 of property taxes on Schedule A, line 6 (real estate taxes). Since they do not own another vacation home in addition to their principal residence, they can deduct the $1,600 of mortgage interest on their second residence on either:

- Schedule A, line 10 (reported on Form 1098), or
- Schedule A, line 11 (not reported on Form 1098).

Note. If Form 1098 was **not** furnished by the developer/seller, the **name, federal identification number, and address** of the developer/seller must be shown on the dotted lines next to line 11.

If the Bakers owned more than one vacation home, they must designate which one is their **second residence** for deducting home mortgage interest on Schedule A.[17] In that case, the informal second home designation may be changed from year to year in order to deduct the highest amount of home mortgage interest.

TIMESHARES RENTED EXCLUSIVELY AND NOT USED PERSONALLY

In order to understand the rationale of taxpayers in this tax situation, some of the complex rules of §280A are shown next.

The rationale of §280A is based on a strict "number of days of **personal use**" (the Code language is **"used by the taxpayer as a residence"**). The greater the "personal use" of the vacation home, the better the chance is that expenses will be limited. A timeshare property is considered to be used as a residence during the tax year if it is used for "personal use" more than the greater of:

1. 14 days, or
2. 10% of the total days it is rented to others at a fair rental price.

If this "personal use" test is **not** met, the timeshare is treated as a rental property and all expenses are deducted on Schedule E, even if a net rental loss results, subject to the passive loss limitation rules for rental real estate. In reality, however, **any timeshare unit which is rented exclusively during the tax year will rarely qualify** for this tax treatment. This is due to the following:

- IRC §280A(d)(2)(A), and
- Proposed Reg. §1.280A-3(f)(3).

The previously cited code and the regulations, in effect, state that the taxpayer who owns a timeshare must compute the days of "personal use" test **not on his own days** of personal use, which would be logical. Instead, the owner of a timeshare must **also consider** the total days of "personal use" of **all of the other owners** of the timeshare unit.

However, the days of "personal use" of the other timeshare owners of the taxpayer's unit are almost **impossible or impractical to obtain**. But if that information was available, the **usual tax result** of following the Code and Regulation is that the **combined "personal use"** of **all** of the multiple owners of the taxpayer's timeshare unit **will exceed** the greater of the 14 days or 10% of total rental days test.

In that scenario, a taxpayer's timeshare unit that is rented exclusively during the tax year must follow the limitation rules discussed next for **Timeshares Used for Dual Purposes**.

Note. Some tax professionals find the logic of these rules so implausible that they ignore it. However, it must be remembered that §280A was written to severely limit expenses of vacation homes which are partially rented and partially used for personal purposes. The theory of §280A is to minimize the tax benefits of taxpayers who occasionally rent vacation homes in order to offset personal expenses. §280A assumes that taxpayers who do this do not have a profit motive in renting the vacation home.

See **Example 18** (shown later) for more details on the tax result when a taxpayer rents his timeshare unit exclusively during the tax year.

TIMESHARES USED FOR DUAL PURPOSES (PERSONAL USE AND RENTAL USE)

For practical purposes, the tax rules discussed for dual-use timeshares will also apply to timeshares that are exclusively rented. **Example 18** shows these tax rules and how to report the rental income and properly allocate the timeshare expenses between Schedule E and Schedule A.

Basic Tax Rules

1. Determine the number of rental days and personal use days during the year. Using those numbers, determine the applicable rental use and personal use percentages.

2. Allocate interest and taxes to Schedules A and E using the ratio determined in Rule 1.

Example 17. A timeshare is available for use to the owner for the last two weeks in March. It is rented for 7 days and used by the owner personally for 7 days in 2003. The Tax Court allocation method results in a **50% allocation** of interest and taxes to both Schedules A and E.

Note.

Example 17 and 18 ignore the Code and Regulation cited in the previous section as the information from all the other owners of the taxpayer's timeshare unit was impossible to obtain.

Example 18 follows the Tax Court's method of allocating **interest and taxes** between Schedules A and E, not the IRS allocation method. The Tax Court's method is generally more favorable to taxpayers as it allows for **greater** "personal use" deductions of interest and taxes on Schedule A.

The "personal use" portion of the **property taxes** are deductible on Schedule A, line 6 (real estate taxes) with no restrictions.

If there is a mixed use of the property during the tax year, the "personal use" portion of the **interest** is **not** deductible on Schedule A, lines 10 or 11 **unless** the taxpayer uses the timeshare unit for **more than 14 days** during the tax year. This prohibition applies to the vast majority of timeshare owners as most timeshare arrangements involve either 1-week or 2-week ownership periods.[18]

3. Any rental income is reported on Schedule E.

4. If there is any rental profit remaining on Schedule E after subtracting the rental portion of interest and taxes from the rental income, deduct the rental portion of other expenses on Schedule E. Examples are:
   - Utilities,
   - Maintenance fees assessed by timeshare association,
   - Insurance,
   - Repairs, and
   - Depreciation (deducted last if any rental profit remains).

5. Total allowable rental deductions on Schedule E using the ordering rules are **limited to the amount of rental income**. Therefore, any net rental **loss** on Schedule E **is not allowed.**

Example 18. Sam and Judy bought a 2-week timeshare in March 2003 for the last two weeks in December. Following is the specific tax information needed to prepare their **2003** tax return.

Purchase price	$40,000
Portion of purchase price allocated to land	$ 5,000
Amount financed with the developer/seller	$25,000
# of days timeshare was used personally in 2003	7
# of days it was rented at fair rental rate to unrelated tenant in 2003	7
2003 rental income	$ 1,000

Timeshare expenses paid in 2003

Property taxes allocable to 2003	$ 200
Mortgage interest (reported on Form 1098)	1,400
Association assessed maintenance fee (not including taxes)	400
Insurance	100
Depreciation	504
[$35,000 × 2.879% MACRS rate for 27.5 year residential rental property – (Table A-6 in IRS Pub. 946) × 50% rental use portion = $504]	

Tax Solution for Example 18. Both the rental use and the personal use percentages are 50%. Using the rules shown previously, Sam and Judy will report the following on their 2003 Schedules A and E:

2003 Schedule A. They can deduct 50% of the $200 property taxes, or $100, on line 6, Schedule A. However, they **cannot** deduct the $700 "personal use" portion of mortgage interest on line 10 because the timeshare was not used more than 14 days for "personal use" in 2003.

2003 Schedule E. The Schedule E of Sam and Judy will reflect the following:

Rental income	$1,000
Less: 50% of property taxes ($200 × 50%)	(100)
Less: 50% of mortgage interest ($1,400 × 50%)	(700)
Balance remaining for other expenses not including depreciation	200
Less: 50% of association maintenance fee and insurance	(200)
($400 + $100 = $500 × 50% = $250 but limited to $200 balance remaining)	
Schedule E net rental loss limited to zero	$ 0

For Example 18

SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074
2003
Attachment Sequence No. 13

Name(s) shown on return: Sam and Judy | Your social security number

Part I Income or Loss From Rental Real Estate and Royalties **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-3). Report farm rental income or loss from **Form 4835** on page 2, line 40.

	1 Show the kind and location of each **rental real estate property:**	2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: ● 14 days **or** ● 10% of the total days rented at fair rental value? (See page E-3.)		Yes	No
A	Timeshare condo Palm Springs, CA		A		X
B			B		
C			C		

		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
Income:						
3 Rents received	3	1,000			3	
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-4)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9					
10 Legal and other professional fees	10					
11 Management fees	11	* 200				
12 Mortgage interest paid to banks, etc. (see page E-4)	12				12	
13 Other interest	13	700				
14 Repairs	14					
15 Supplies	15					
16 Taxes	16	100				
17 Utilities	17					
18 Other (list) ▶ * Management fees of $200 plus insurance of $50 limited by Sec. 280A to $200 (line 11 above)	18					
19 Add lines 5 through 18	19	1,000			19	
20 Depreciation expense or depletion (see page E-4)	20	0			20	
21 Total expenses. Add lines 19 and 20	21	1,000				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-5 to find out if you must file **Form 6198**	22	0				
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file **Form 8582.** Real estate professionals must complete line 43 on page 2	23	( )	( )	( )		
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses					24	0
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here					25	( )
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2					26	0

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L **Schedule E (Form 1040) 2003**

SALES OF TIMESHARES

In many cases, the taxpayer will sell his deeded timeshare interest at a loss. This is usually the case since many timeshare owners overpay the developer/seller when the timeshare is initially purchased. If that is true, it is very difficult for the owner to enjoy any appreciation in the timeshare. In addition, it is generally more difficult to sell a timeshare interest than it is to sell other real estate. Consequently, sales commissions charged by the real estate broker tend to be very high.

Often, the developer from whom the taxpayer bought the timeshare will resell it. Or, due to the popularity of Internet auction sites such as eBay, the timeshare owners will attempt to sell the timeshare themselves in order to avoid high sales commissions. The following examples show the tax results for dispositions of timeshares under various factual situations.

Example 19. Megan bought a 1-week timeshare condominium in Orlando, FL, in 1998 for $12,000. She used it only for personal purposes in 1998–2002. She sold it through the developer in 2003 for a net sales price of $7,000 (after the $1,000 sales commission was deducted by the developer).

Tax Solution for Example 19. Megan has a **nondeductible loss** of $5,000 on the 2003 sale of her timeshare since it is a personal-use asset.

Example 20. Tim bought a 2-week timeshare in Orlando, FL, in 1998 for $20,000. He rented it exclusively during the time he owned it. He sold it in 2003 for a net sales price of $12,000. He claimed $1,000 of MACRS depreciation on it.

Tax Solution for Example 20. Tim has a **§1231 loss** of $7,000 on the 2003 sale of his timeshare. He will report the sale in Form 4797, Part I.

Example 21. Lloyd bought a 2-week timeshare in Scottsdale, AZ, in March 1998 for $15,000. He sold it in November 2003 for a net sales price of $10,000. He used it for both rental and personal purposes in 1998 and 1999. He was entitled to no depreciation deductions in 1998 and 1999 due to the §280A limitations. However, during 2000, 2001, 2002, and 2003, he used it exclusively for personal purposes.

Tax Solution for Example 21. While Lloyd may take the position that his timeshare was used for dual purposes, an IRS examiner will likely hold that it was a personal-use asset on the date of sale. The fact that Lloyd did **not** rent the timeshare during the last four tax years he owned it is sufficient to properly classify it as a personal-use asset on the date of sale in November 2003. Therefore, Lloyd has a **nondeductible loss** of $5,000 on the 2003 sale of his timeshare.

Example 22. The facts are the same as **Example 21,** except Lloyd consistently lived in the timeshare for one week and rented it for the other week during the entire ownership period.

Tax Solution for Example 22. Lloyd owns a dual-purpose timeshare on the date of sale in November 2003. He must report **two sales** and make allocations between them.

The rental portion sale will be reported in Form 4797, Part I. Lloyd has a §1231 loss of $2,500.

Sales price (50% of $10,000)	$5,000
Less: Basis (50% of $15,000 purchase price)	(7,500)
§1231 loss on 2003 Form 4797	($2,500)

Lloyd has a **nondeductible loss** of $2,500 on the personal-use portion of the sale.

Note. Timeshares will never qualify for the §121 exclusion on the gain of the sale of a principal residence since the personal-use period covers only a small fraction of any tax year.

PROBLEM 7: VERIFICATION OF GAMBLING LOSSES

BACKGROUND INFORMATION

The opportunities for taxpayers to gamble legally have never been greater. Based on statistics from state gambling commissions, these opportunities have resulted in ever larger totals of gross wagers for the last decade. The problem facing many tax practitioners is how to treat real or alleged gambling losses of clients who bring them Forms W-2G for gambling winnings. Such losses can be deducted only up to the amount of gambling winnings reported as other income on line 21, Form 1040.

The issue of deducting gambling losses on Schedule A to offset gambling winnings is a highly litigated area. In the majority of court case decisions, the courts have ruled in one of two ways:

- Disallowed all claimed gambling losses due to lack of required records
- Allowed less than the amount of claimed gambling losses based on an estimation sanctioned under the often used ***Cohan*** rule (used in the 1930 *George M. Cohan* court case to allow a portion of unsubstantiated expenses)

This is an area that can create friction between the client and the preparer. However, the rules are very clear. **Revenue Procedure 77-29** (1997-2 C.B. 538) was written by the IRS to specifically address the required documentation to support a deduction for gambling losses. The full contents of the Revenue Procedure and comments and observations concerning it follow.

> **Tip.** Practitioners may want to show these precise record keeping rules to their gambling clients. Also, practitioners may want to caution clients about the potentially severe tax results of failure to maintain an accurate daily gambling diary or log.

REVENUE PROCEDURE 77-29

SECTION 3. PROCEDURES

An accurate diary or similar record regularly maintained by the taxpayer, supplemented by verifiable documentation, will usually be acceptable evidence for substantiation of wagering winnings and losses. In general, the diary should contain at least the following information:

1. *Date and type of specific wager or wagering activity.*
2. *Name of gambling establishment.*
3. *Address or location of gambling establishment.*
4. *Name(s) of other person(s) (if any) present with taxpayer at gambling establishment.*
5. *Amount(s) won or lost.*

Verifiable documentation for gambling transactions includes but is not limited to Forms W-2G; Forms 5754, Statement by Person Receiving Gambling Winnings; wagering tickets, canceled checks, credit records, bank withdrawals, and statements of actual winnings or payment slips provided to the taxpayer by the gambling establishment.

Where possible, the diary and available documentation generated with the placement and settlement of a wager should be further supported by other documentation of the taxpayer's wagering activity or visit to a gambling establishment. Such documentation includes, but is not limited to, hotel bills, airline tickets, gasoline credit cards, canceled checks, credit records, bank deposits, and bank withdrawals.

Additional supporting evidence could also include affidavits or testimony from responsible gambling officials regarding wagering activity.

With regard to specific wagering transactions, winnings and losses may be further supported by the following items:

.01 Keno — Copies of keno tickets purchased by the taxpayer and validated by the gambling establishment, copies of the taxpayer's casino credit records, and copies of the taxpayer's casino check cashing records.

.02 Slot Machines — A record of all winnings by date and time that the machine was played. (In Nevada, the machine number is the number required by the State Gaming Commission and may or may not be displayed in a prominent place on the machine. If not displayed on the machine, the number may be requested from the casino operator.)

.03 Table Games — Twenty-One (Blackjack), Craps, Poker, Baccarat, Roulette, Wheel of Fortune, Etc. – The number of the table at which the taxpayer was playing. Casino credit card data indicating whether the credit was issued in the pit or at the cashier's cage.

.04 Bingo — A record of the number of games played, cost of tickets purchased and amounts collected on winning tickets. Supplemental records include any receipts from the casino, parlor, etc.

.05 Racing — Horse, Harness, Dog, Etc. – A record of the races, entries, amounts of wagers, and amounts collected on winning tickets and amounts lost on losing tickets. Supplemental records include unredeemed tickets and payment records from the racetrack.

.06 Lotteries — A record of ticket purchases, dates, winnings, and losses. Supplemental records include unredeemed tickets, payments slips, and winnings statement.

SECTION 4. LIMITATIONS

The record-keeping suggestions set forth above are intended as general guidelines to assist taxpayers in establishing their reportable gambling gains and deductible gambling losses. While following these will enable most taxpayers to meet their obligations under the Internal Revenue Code these guidelines cannot be all inclusive and the tax liability of each depends on the facts and circumstances of particular situations.

COMMENTS AND OBSERVATIONS

1. A daily diary or log is a necessity to verify gambling activity. The diary must show the following:
   - The type of game played (blackjack, slot machines, etc.)
   - The date and location where the gambling takes place
   - The wins and losses for **each game or session**
   - Names of others present
2. It might be helpful to transfer the information from the daily diary to a computer spreadsheet. This type of contemporaneous record keeping will be very persuasive in case IRS examines the tax return.
3. Other corroborating information is also recommended, such as:
   - Casino printouts, which show a member's card activity,
   - Racetrack programs, and
   - Bank or credit withdrawal information.

4. The reported winnings of taxpayers who gamble frequently should include **all** winnings, not just the occasional large wins evidenced by Forms W-2G. These **total yearly winnings** must be reported on line 21, Form 1040 (Other income).

Note. As shown in many of the court cases, the IRS is more likely to accept reported gambling losses deducted on Schedule A if the taxpayer has reported all gambling winnings on line 21, Form 1040.

5. In an exam of a taxpayer who has large reported winnings and losses, the IRS examiner may conduct an **indirect exam method** in an attempt to prove that the taxpayer's claimed losses are excessive.

Excerpt from the *J. D. Zielonka* Tax Court Memo case

We [the Tax Court] recognize that the taxpayer must have sustained some losses in view of his substantial gambling activity. However, we are reminded of the taxpayer's testimony that he estimated a portion of the gambling winnings he reported on his 1992 return.

Moreover, the gambling winnings that were reported on his 1989 return appear to represent only those winnings for which Forms W-2G were issued. Thus, we have no assurance that the taxpayer reported all of his gambling winnings.

This uncertainty, together with the complete absence of any documentation or other credible corroborating evidence concerning his gambling activity, precludes us from estimating his alleged losses under the rule of Cohan v. Commissioner. Accordingly, we hold that the taxpayer has failed to carry his burden of proof. Therefore, he is not entitled to deduct any gambling losses for either 1989 or 1992. [J.D. Zielonka, Tax Court Memo 1997-81, 73 TCM 2026, CCH Dec. 51,886(M)]

FORM W-2G REPORTING CRITERIA

- **What to Report.** Gambling winnings from horse racing, dog racing, jai alai, lotteries, keno, slot machines, sweepstakes, bingo, wagering pools, etc.
- **Amounts Reportable.** Generally, $600 or more; $1,200 or more from bingo or slot machines; $1,500 or more from keno
- **Withholding Rate on Gambling Winnings for 2003.** 25% (changed by the JGTRR Act of 2003)

OTHER GAMBLING TAX INFORMATION

- A husband and wife who file jointly may **combine** their gambling winnings and losses for tax reporting purposes.[19]
- Gambling losses (to the extent of reported winnings) are deducted on line 27, Schedule A (Other miscellaneous deductions) and **are not subject to the 2% of AGI limitation**.

Example 23. Ima Loser works the night shift at a factory. She is a regular visitor to Arlington International Racecourse, a thoroughbred horse track. She attends the track a minimum of three days a week for the five months it is open in 2003. In 2003, she won seven large trifectas and one large daily double wager for which she received 2003 Forms W-2G. The **total winnings** reported to Ms. Loser on the eight Forms W-2G were $8,600.

She asks Les Dohe, her accountant, to prepare her 2003 tax return. She gives Les the eight 2003 Forms W-2G and a stack of stapled losing wager tickets from the track. She tells him that she:

- Keeps a record of all wins and losses for each race on the race program,
- Staples the losing tickets together for each day's activity, and
- Adds each day's winnings and losses and enters the net figure in a diary. She uses a black pen for net winnings and a red pen for net losses.

Les inspects these records and verifies Ms. Loser's arithmetic is correct for 15 sample days. According to her diary entries, her **net gambling loss for 2003 is $9,203**, consisting of:

a)	Total of daily winnings	$12,704
b)	Total of daily losses	(21,907)
	Net gambling loss for 2003	($ 9,203)

Ms. Loser volunteers that attending the track is her main hobby and that she has been doing this for the last ten years. She states her winnings exceeded her losses only in one year, and then only barely. She tells Les that she enjoys her hobby and attends the track even in bad weather.

Tax Solution for Example 23. It appears Ms. Loser is credible and that her records comply with Rev. Proc. 77-29. Therefore, her 2003 return will report the following:

Gambling winnings reported on line 21, Form 1040 (Other income)	$12,704
Gambling losses (to the extent of winnings) deducted on line 27, Schedule A (not subject to the 2% AGI limitation)	$12,704

The final portion of Problem 7 shows two casino printouts which clients may furnish to practitioners to prove gambling losses. However, the printouts are no substitute for a taxpayer's required daily diary or log.

Note. The IRS will not automatically accept a casino printout based on the taxpayer's member card activity since the taxpayer may have allowed someone else to use the card.

Empress Joliet
2002
Annual Activity Report

Club member:
Lucinda Lucky
711 Wager St.
Oak Park, IL 60304

Account #: 7777

Player #: 7777

Gaming Activity

Gaming Area	Dollars In	Dollars Out	Win/Loss	Jackpots	Adjusted Win/Loss	#W2G Level Jackpots	W2G Level Jackpots
SLOT	76,112.00	69,781.00	-6,331.00	3,340.00	-2,991.00	0	0.00
Totals	76,112.00	69,781.00	-6,331.00	3,340.00	-2,991.00	0	0.00

04-12-2002 Empress Joliet 14:33:02

MEMBER PLAY BY PERIOD

MEMBER ID. 7777 NAME: LUCINDA LUCKY LAST PLAY 10-19-2002

	LAST PLAY	MTD	YTD	LAST YEAR	STD
COIN IN	$6,178.00	$7,372.00	$369,913.80	$799,806.50	$2,030,926.50
COIN OUT	$5,850.00	$6,763.00	$342,964.30	$760,831.00	$1,957,189.05
JACKPOTS	$0.00	$0.00	$35,119.00	$57,970.00	$141,044.00
MEM WIN	($328.00)	($609.00)	$8,169.50	$18,994.50	$67,306.55

CURRENT TRIP INFORMATION

TRIP START	10/19/2002 18:24:06	ELAPSED DAYS	1
LAST ACTIVITY	10/19/2002 22:41:36	ESTIMATED DAILY WORTH	$253.04

COIN IN	$6,345.00	EARNED PTS	11,892	EARNED COMP	5946
COIN OUT	$5,946.00	REDEEMED PTS	12,500	REDEEMED COMP	0
JACKPOTS	$0.00	ADJUSTED PTS	0	ADJUSTED COMP	0
MEMWIN	($399.00)	BALANCE PTS	(608)	BALANCE COMP	5946
THEO WIN	$253.04				

PROBLEM 8: SALE OF PASSIVE ACTIVITY PROPERTY WITH SUSPENDED LOSSES

Example 24. Marcus Allen, a surgeon with high AGI, bought an apartment building on June 1, 1985, as a tax shelter. Since 1987, Dr. Allen has been unable to deduct the considerable losses generated by this rental real estate activity due to the passive loss limitations of §469. As of December 31, 2002, his **suspended losses** from this activity totaled $178,000. Dr. Allen owns no other passive activities. He actively participated in the management of the apartment building.

On June 1, 2003, Dr. Allen sold the apartment building for $760,000, resulting in a **taxable gain on the 2003 Form 4797 of $235,000.** The sale was not an installment sale and the buyer was not related to Dr. Allen.

Dr. Allen rented the apartment building for the first five months of 2003. The 2003 rental activity produced a $4,000 loss on the 2003 Schedule E.

Question A. Is the $178,000 suspended loss carryover to 2003 deductible on Dr. Allen's 2003 Form 1040?

Answer A. Yes. Any passive activity losses that have not been allowed (suspended losses) generally are allowed in full in the tax year the passive activity property is sold in a fully taxable transaction. In order for the suspended losses to be deductible, the disposition must meet the following rules:

1. The taxpayer's **entire interest** in the passive activity must be disposed of.
2. All of the realized gain is recognized.
3. The person acquiring the entire interest must **not be related** to the taxpayer.[20]

Question B. Is the current year Schedule E rental loss of $4,000 deductible on Dr. Allen's 2003 Form 1040?

Answer B. Yes.

Question C. Where will the prior years' suspended losses of $178,000 and the current year (2003) rental loss of $4,000 be shown on Dr. Allen's 2003 Form 1040?

Answer C. On the 2003 Schedule E. See the completed 2003 Schedule E and 2002 Form 8582 for Dr. Allen. The 2003 Form 4797, which will report the $235,000 gain on the sale of the apartment building, is not shown.

Excerpt from 2002 Form 8582 Instructions

If you completely dispose of your entire interest in a passive activity, you may have to report net income or loss and prior year unallowed losses from the activity. Combine all income and losses (including any prior year unallowed losses) from the activity for the tax year to see if you have an ***overall gain or loss.***

If you have an ***overall gain*** *and this is your* ***only*** *passive activity, report all income and losses (including any prior year unallowed losses)* ***on the forms and schedules normally used*** *and skip the worksheets and Form 8582.*

Computation of Overall Gain/Loss from Passive Activity in 2003

1. Taxable gain reported on Form 4797 (form not shown)	$235,000
2. Prior year unallowed (suspended) losses (see the 2002 Form 8582)	(178,000)
3. 2003 net rental loss for the first five months (see the 2003 Schedule E)	(4,000)
Overall gain from the passive activity in 2003 (year of disposition)	$ 53,000

For Example 24

SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

► Attach to Form 1040 or Form 1041. ► See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074
2003
Attachment Sequence No. 13

Name(s) shown on return: **Marcus Allen**
Your social security number: **555 55 5555**

Part I — Income or Loss From Rental Real Estate and Royalties **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-3). Report farm rental income or loss from **Form 4835** on page 2, line 40.

1 Show the kind and location of each **rental real estate property:**

	Property	Yes	No
A	**Apartment Building** **1300 S. DelMar, Topeka, KS**		X
B			
C			

2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:
- 14 days **or**
- 10% of the total days rented at fair rental value?

(See page E-3.)

Income:	Line	A	B	C	Totals (Add columns A, B, and C.)
3 Rents received	3	80,000			3
4 Royalties received	4				4
Expenses:					
5 Advertising	5				
6 Auto and travel (see page E-4)	6				
7 Cleaning and maintenance	7	2,000			
8 Commissions	8				
9 Insurance	9	8,000			
10 Legal and other professional fees	10				
11 Management fees	11				
12 Mortgage interest paid to banks, etc. (see page E-4)	12	7,000			12
13 Other interest	13				
14 Repairs	14	16,000			
15 Supplies	15	2,000			
16 Taxes	16	29,000			
17 Utilities	17	14,000			
18 Other (list) ► **Suspended loss carried forward to 2003 per line 1d of the 2002 Form 8582**	18	178,000			
19 Add lines 5 through 18	19				19
20 Depreciation expense or depletion (see page E-4)	20	6,000			20
21 Total expenses. Add lines 19 and 20	21	262,000			
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-5 to find out if you must file **Form 6198**	22	(182,000)			
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file **Form 8582.** Real estate professionals must complete line 43 on page 2	23	(182,000)	( )	( )	

24	**Income.** Add positive amounts shown on line 22. **Do not** include any losses	24
25	**Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25 ( )
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2	26

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L **Schedule E (Form 1040) 2003**

For Example 24

Form **8582**

Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1041.

OMB No. 1545-1008
2002
Attachment Sequence No. 88

Name(s) shown on return: Marcus Allen | Identifying number: 555-55-5555

Part I **2002 Passive Activity Loss**

Caution: *See the instructions for Worksheets 1, 2, and 3 on pages 7 and 8 before completing Part I.*

Rental Real Estate Activities With Active Participation (For the definition of active participation see **Special Allowance for Rental Real Estate Activities** on page 3 of the instructions.)

1a	Activities with net income (enter the amount from Worksheet 1, column (a))	1a		
b	Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	(10,000)	
c	Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c	(168,000)	
d	Combine lines 1a, 1b, and 1c		1d	(178,000)

Commercial Revitalization Deductions From Rental Real Estate Activities

2a	Commercial revitalization deductions from Worksheet 2, column (a)	2a	( )	
b	Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b	( )	
c	Add lines 2a and 2b		2c	( )

All Other Passive Activities

3a	Activities with net income (enter the amount from Worksheet 3, column (a))	3a		
b	Activities with net loss (enter the amount from Worksheet 3, column (b))	3b	( )	
c	Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	3c	( )	
d	Combine lines 3a, 3b, and 3c		3d	

4	Combine lines 1d, 2c, and 3d. If the result is net income or zero, all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. **Do not** complete Form 8582. Report the losses on the forms and schedules normally used	4	(178,000)

If line 4 is a loss and:
- Line 1d is a loss, go to Part II.
- Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
- Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

Caution: *If your filing status is married filing separately and you lived with your spouse at any time during the year,* ***do not*** *complete Part II or Part III. Instead, go to line 15.*

Part II **Special Allowance for Rental Real Estate With Active Participation**

Note: *Enter all numbers in Part II as positive amounts. See page 8 for an example.*

5	Enter the **smaller** of the loss on line 1d or the loss on line 4			5	178,000
6	Enter $150,000. If married filing separately, see page 8	6	150,000		
7	Enter modified adjusted gross income, but not less than zero (see page 8)	7	430,000		
	Note: *If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.*				
8	Subtract line 7 from line 6	8			
9	Multiply line 8 by 50% (.5). **Do not** enter more than $25,000. If married filing separately, see page 9			9	
10	Enter the **smaller** of line 5 or line 9			10	0

If line 2c is a loss, go to Part III. Otherwise, go to line 15.

Part III **Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities**

Note: *Enter all numbers in Part III as positive amounts. See the example for Part II on page 8.*

11	Enter $25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	11	
12	Enter the loss from line 4	12	
13	Reduce line 12 by the amount on line 10	13	
14	Enter the **smallest** of line 2c (treated as a positive amount), line 11, or line 13	14	

Part IV **Total Losses Allowed**

15	Add the income, if any, on lines 1a and 3a and enter the total	15	0
16	**Total losses allowed from all passive activities for 2002.** Add lines 10, 14, and 15. See page 11 of the instructions to find out how to report the losses on your tax return	16	0

For Paperwork Reduction Act Notice, see page 12 of the instructions. Cat. No. 63704F Form **8582** (2002)

Note.

1. If Dr. Allen had passive activities **other than** the apartment building in 2003, it would be necessary to complete Worksheet 1 on page 2 of the 2003 Form 8582. In that case, the 2003 Form 8582 and any completed Worksheets must be attached to his 2003 Form 1040.

2. If Dr. Allen had an **overall loss** from the apartment building in 2003, it would not be necessary to prepare a 2003 Form 8582 or the Worksheets. All losses, including the $178,000 suspended loss, **would be deductible** on the 2003 Schedule E.

ENDNOTES

1 Treas. Reg. §1.121-1(e)(1)
2 Treas. Reg. §1.121-1(e)(4), Example 5
3 Treas. Reg. §1.121-1(e)(1)
4 Treas. Reg. §1.121-2(a)(2) and (4), Example 1
5 Treas. Reg. §1.121-1(b)(3)(i)
6 Treas. Reg. §1.121-1(b)(4), Example 3
7 Temp. Reg. §1.121-3T(c) and (f)
8 Temp. Reg. §1.121-3T(d) and (f)
9 Temp. Reg. §1.121-3T(e)
10 Temp. Reg. §1.121-3T(b)
11 Temp. Reg. §1.121-3T(e)(1)
12 IRC §23(e)
13 *TC Memo 2002-196*
14 IRS Pub. 590, *Individual Retirement Arrangements* (For Use in Preparing 2002 Returns), page 62
15 IRS Pub. 575, *Pension and Annuity Income* (For Use in Preparing 2002 Returns), pages 4 and 19
16 Craig, Caroline K. and Luttman, Suzanne M., *Journal of Real Estate Taxation*, Summer 2000, "Taxation of Timeshares — Acquisition, Use, and Disposition Issues"
17 IRC §163(h)(3)
18 Temp. Reg. §1.163-10T(p)(3)(iii) and (p)(6)
19 Treas. Reg. §1.165-10
20 IRC §469(g)(1)