Chapter 1: Individual Taxpayer Problems

Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

PROBLEM 1: CLASS ACTION LAWSUIT SETTLEMENTS — SECURITIES VIOLATIONS

BACKGROUND INFORMATION

A flood of investor-initiated lawsuits for alleged securities violations was one of the results of the stock market meltdown that began in early 2000. **Class action lawsuits** filed against brokerage and mutual fund companies affected the greatest number of investors. Many of these lawsuits will be finalized in 2004, and members of the class action litigation will receive their court-approved settlements. The following example presents a situation in which a mutual fund company paid a settlement resulting from a class action suit.

Facts. Rick and Lynette McCall bought and sold shares in Midwest Municipal Bond Fund. The monthly dividends were received in cash and not reinvested. The following schedule shows their purchase and sale of shares in this mutual fund.

Date Purchased	Shares Purchased	Purchase Price/Share	Total Cost Basis
Feb. 18, 1999	6,666.667	$10.50	$70,000
Date Sold	**Shares Sold**	**Sales Price/Share**	**Total Sales Proceeds**
Dec. 30, 1999	6,666.667	$8.25	$55,000

Rick and Lynette reported the **$15,000 short-term capital loss** on this sale on their **1999 Schedule D,** along with other capital gains and losses. Because of subsequent losses, **they still have a $5,000 short-term capital loss carryover from 2003 to 2004.**

They were members of a class action litigation against the Midwest Group, Inc. (Midwest). The lawsuit originated in the U.S. District Court, and alleged that:

- Officers of Midwest committed several acts in violation of SEC regulations.
- These improper acts misled investors who purchased shares in Midwest Municipal Bond Fund during the class period.
- Midwest's improper acts reduced the value of the fund shares, which in turn harmed investors who bought or sold shares during the class period.

The class period alleged in the litigation began on January 3, 1998, and ran through and included October 10, 2000. Since Rick and Lynette bought their shares in the fund during the class period, they were entitled to share in any settlement proceeds.

Although Midwest admitted to no wrongdoing, it agreed to disburse a $1 million settlement to class action members who filed the proper claims with the court. Rick and Lynette received their settlement check on November 15, 2004, in the amount of $700.

A letter which accompanied their check stated the following:

1. No 2004 Form 1099 will be provided for the settlement check of $700.
2. Check with your tax advisor for the correct tax treatment of this settlement check.

> **Note.** Rick and Lynette paid no attorney fees as the fees were awarded directly to the plaintiffs' law firm by the court. This procedure is referred to as the "common fund theory of recovery." The tax result is that Rick and Lynette do not have to include their portion of the court-awarded attorney fees in their 2004 gross income.[1] This tax result applies to "opt-out" class action lawsuits which are common in securities violations proceedings.

Discussion of Law. The Supreme Court formulated the proper tax treatment of damages received for court-ordered judgments and court-approved settlements. This is the **"origin and nature of the claim"** rule, and under this theory, the "origin and nature of the claim" determines how the settlement is treated for tax purposes.[2]

In particular, the "origin and nature of the claim" theory holds that monetary damages assume the same character as the original property that was lost or damaged for the purposes of reporting taxable income. **Therefore, damages received for harm to capital assets (such as mutual fund shares) are treated as a capital gain if they exceed the property's basis.**

However, if the damages do **not** exceed the property's basis, the damage proceeds are considered a nontaxable capital return.

Since the lawsuit compensated Rick and Lynette for the reduction in the value of their shares during the class period, the $700 settlement is capital in nature. The lawsuit did not allege that the improper actions caused a reduction in dividends, only that the value of shares was diminished.

Solution. Since Rick and Lynette already reported their entire $15,000 short-term capital loss on their sale of Midwest Municipal Bond Fund on their 1999 Schedule D, they effectively accounted for all of their $70,000 basis. The nature of their original 1999 capital loss on the sale was short-term. **Therefore, the $700 settlement check they received in 2004 is treated as a short-term capital gain.** This should be reported as a short-term sale with zero basis in Part I of their 2004 Schedule D.

Assume Rick and Lynette's only other reportable 2004 capital gain or loss is a $2,000 short-term gain on the sale of a vacant lot. The solution is shown on their 2004 Schedule D.

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1. Letter Ruling 200316040
2. *United States v. Don Gilmore,* 372 US 39, 63-1 USTC ¶9285, February 18, 1963

1

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

2004

Attachment Sequence No. 12

Name(s) shown on Form 1040: Rick and Lynette McCall

Your social security number: 222 22 2222

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

(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-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 Class Action Settlement Award	NA	11/15/04	700 00	0	700 00
Vacant Lot	02/10/04	12/20/04	32,000 00	30,000 00	2,000 00
2 Enter your short-term totals, if any, from Schedule D-1, line 2		2			
3 **Total short-term sales price amounts.** Add lines 1 and 2 in column (d)		3	32,700 00		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** on page D-5 of the Instructions				6	(5,000 00)
7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)				7	(2,300 00)

Note. See IRS Notice 2004-27 in the Capital Gains and Losses section of the Rulings and Cases chapter for more information on stock value declines caused by corporate misconduct.

PROBLEM 2: DIVORCE TAXATION ISSUES

FORM 8332

The IRS has recently revised Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*.

In response to the Tax Court's decision in the *King*[3] case, **the IRS now agrees that a custodial parent who was never married can use Form 8332 to properly release claiming a child's exemption** for the benefit of the non-custodial parent, assuming the special support test of IRC§152(e)(1) is met.

Special Support Test Rules. These rules state that the **parent who has custody for the greater portion of the calendar year (the custodial parent)** has provided over half of a child's support if:

- The child received over half of his support for the year from one or both parents, **and**
- The child was in the custody of one or both parents for more than half of the year.

In order for these special support test rules to apply, the parents must be one of the following:

1. Divorced or legally separated under a decree of divorce or separate maintenance,
2. Separated under a written separation agreement, or
3. Living apart at all times during the last six months of the year.

Example 1. Michael and Vickie are the parents of Ashleigh, their daughter, who turned age seven in 2004. Michael and Vickie were never married. Ashleigh lived all of 2004 in a residence owned by Vickie and her husband Mel.

Result of the revision. Vickie is allowed to execute Form 8332 to waive Ashleigh's exemption for the benefit of Michael. Prior to the revision, parents who were never married could not use Form 8332 .

> **Note.** See the *King* case analysis in the Dependency Issues section of the Rulings and Cases chapter.

3. *Jeffrey R. and Sabrina M. King v. Commr.,* 121 TC 245, No.12, September 26, 2003

Form **8332**
(Rev. December 2003)
Department of the Treasury
Internal Revenue Service

Release of Claim to Exemption for Child of Divorced or Separated Parents

▶ **Attach** to noncustodial parent's return **each year** exemption is claimed.

OMB No. 1545-0915

Attachment Sequence No. **115**

Name of noncustodial parent claiming exemption	Noncustodial parent's social security number (SSN) ▶

Part I **Release of Claim to Exemption for Current Year**

I agree not to claim an exemption for ______________________________
Name(s) of child (or children)

for the tax year 20_____ .

______________________________ Signature of custodial parent releasing claim to exemption
______________ Custodial parent's SSN
__________ Date

Note: *If you choose not to claim an exemption for this child (or children) for future tax years, also complete Part II.*

Part II **Release of Claim to Exemption for Future Years** (If completed, see **Noncustodial parent** below.)

I agree not to claim an exemption for ______________________________
Name(s) of child (or children)

for the tax year(s)______________________________ .
(Specify. See instructions.)

______________________________ Signature of custodial parent releasing claim to exemption
______________ Custodial parent's SSN
__________ Date

General Instructions

Purpose of form. If you are a **custodial parent,** you may use this form to release your claim to your child's exemption. To do so, complete this form (or a similar statement containing the same information required by this form) and give it to the noncustodial parent who will claim the child's exemption. The noncustodial parent must attach this form or similar statement to his or her tax return **each year** the exemption is claimed.

You are the **custodial parent** if you had custody of the child for most of the year. You are the **noncustodial parent** if you had custody for a shorter period of time or did not have custody at all. For the definition of custody, see **Pub. 501,** Exemptions, Standard Deduction, and Filing Information.

Support test for children of divorced or separated parents. Generally, the custodial parent is treated as having provided over half of the child's support if:

- The child received over half of his or her total support for the year from one or both of the parents **and**
- The child was in the custody of one or both of the parents for more than half of the year.

Note: *Public assistance payments, such as Temporary Assistance for Needy Families (TANF), are not support provided by the parents.*

For this support test to apply, the parents must be one of the following:

- Divorced or legally separated under a decree of divorce or separate maintenance,
- Separated under a written separation agreement, **or**
- Living apart at all times during the last 6 months of the year.

If the support test applies, and the other four dependency tests in your tax return instruction booklet are also met, the custodial parent can claim the child's exemption.

Exception. The custodial parent will not be treated as having provided over half of the child's support if **any** of the following apply.

- The custodial parent agrees not to claim the child's exemption by signing this form or similar statement.
- The child is treated as having received over half of his or her total support from a person under a multiple support agreement (**Form 2120,** Multiple Support Declaration).
- A pre-1985 divorce decree or written separation agreement states that the noncustodial parent can claim the child as a dependent. But the noncustodial parent must provide at least $600 for the child's support during the year. This rule does not apply if the decree or agreement was changed after 1984 to say that the noncustodial parent cannot claim the child as a dependent.

Additional information. For more details, see **Pub. 504,** Divorced or Separated Individuals.

Specific Instructions

Custodial parent. You may agree to release your claim to the child's exemption for the current tax year or for future years, or both.

- Complete **Part I** if you agree to release your claim to the child's exemption for the current tax year.
- Complete **Part II** if you agree to release your claim to the child's exemption for any or all future years. If you do, write the specific future year(s) or "all future years" in the space provided in Part II.

TIP To help ensure future support, you may not want to release your claim to the child's exemption for future years.

Noncustodial parent. Attach this form or similar statement to your tax return for **each year** you claim the child's exemption. You may claim the exemption **only** if the other four dependency tests in your tax return instruction booklet are met.

Note: *If the custodial parent released his or her claim to the child's exemption for any future year, you **must** attach a copy of this form or similar statement to your tax return for each future year that you claim the exemption. **Keep a copy for your records.***

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	6 min.
Learning about the law or the form	5 min.
Preparing the form	7 min.
Copying, assembling, and sending the form to the IRS	13 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Products Coordinating Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send the form to this address. Instead, see the Instructions for Form 1040 or Form 1040A.

Cat. No. 13910F Form **8332** (Rev. 12-2003)

DIVORCE DECREE OR SEPARATION AGREEMENT AS A SUBSTITUTE FOR FORM 8332

Based on a number of recent Tax Court cases, this topic clearly warrants clarification.

Excerpt from IRS Pub. 504, *Divorced or Separated Individuals* (for use in preparing 2003 returns).

Written Declaration. *The custodial parent should use* ***Form 8332****, or a similar statement (containing the information required by the form), to make the written declaration to release the exemption to the non-custodial parent. The non-custodial parent must attach the form or statement to his or her tax return.*

Divorce Decree Made after 1984. *If your divorce decree or separation agreement was executed after 1984, you do* ***not*** *have to attach Form 8332 or a similar statement if both of the following requirements are met.*

1. *The decree or agreement states all of the following:*
   - **a.** *The custodial parent will not claim the child as a dependent.*
   - **b.** *The non-custodial parent can claim the child as a dependent without regard to any condition, such as the payment of child support.*
   - **c.** *The years for which the non-custodial parent can claim the child as a dependent.*
2. *The non-custodial parent attaches a copy of the following pages of the decree or agreement to his or her return for the tax year:*
   - **a.** *The cover page (write the other parent's social security number on this page).*
   - **b.** *The pages that contain the information shown in item (1) above.*
   - **c.** *The signature page with the other parent's signature and the date of the agreement.*

Example 2. Ben and Jennifer were divorced in 1995. The **divorce decree failed to include Ben's and Jennifer's signatures.** The decree stated that Ben could claim their daughter Tracy as an exemption on his tax returns **provided** he was current in the required child support payments at the end of the year. Jennifer was awarded custody of Tracy. Tracy, age 12, lived all of 2004 with her mother, Jennifer.

Tax Solution for Example 2. Without a signed Form 8332 or similar statement from Jennifer, Ben is not entitled to claim Tracy's exemption on his 2004 tax return. There are two reasons for this conclusion:

1. The divorce decree does not contain Ben's and Jennifer's signatures.
2. Even if the divorce decree contained both signatures, Ben was **not unconditionally** allowed to claim his daughter's exemption. He was allowed to claim Tracy's exemption on the condition that he kept current with his child support obligations.

> **Note.** See pages 586–587 in the *2003 University of Illinois Federal Tax Workbook* for the *Loffer* TC Memo case. The decision in the *Loffer* case is similar to the solution shown above in **Example 2** for Ben and Jennifer.

QUALIFIED DOMESTIC RELATIONS ORDERS (QDROs)

What Is a QDRO?

A qualified domestic relations order (QDRO) is a judgment, decree, or court order (including an approved property settlement agreement) issued under a domestic relations law that:

1. Creates the rights of a spouse, former spouse, child, or other dependent of the participant to receive benefits from a participant's qualified retirement plan (such as most pension and profit-sharing plans) or tax-sheltered annuity,

2. Relates to payments of child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of the participant, and
3. Clearly specifies the amount or portion of the participant's benefits to be paid; the names and addresses of the participant's spouse, child, or dependent to receive; and details a schedule of such payments.

A QDRO may require the retirement plan to begin making benefit distributions to an alternate payee (usually one party to a divorce) when the plan participant/employee (usually the other party to the divorce) reaches the **earliest retirement age**, regardless of whether he actually retires on that date.

Example 3. Bill and Jill are getting divorced. Bill, who is age 51, can elect early retirement from his job with AMEX Corp. at age 55. Even though Bill wants to work until he is age 65, Jill's divorce attorney can negotiate with Bill's attorney to allow Jill to begin receiving a portion of Bill's retirement benefits once he reaches age 55. If both parties agree to this in the divorce decree, a QDRO must be prepared and given to Bill's retirement plan administrator prior to Bill's 55th birthday.

> **Note.** The Pension Benefit Guaranty Corporation (PBGC) issued a 32-page booklet entitled ***Divorce Orders and PBGC***. It is designed to help attorneys and others who are working with divorced clients. It explains how to properly draft a QDRO to satisfy the needs of the retirement plan administrator. The booklet can be obtained by calling 800-400-7242 or downloading the information from the PBGC website at www.pbgc.gov.

It is important that the ex-spouse who uses a QDRO obtain retirement benefits as an alternate payee as quickly as possible. The rights of a party to a divorce (alternate payee) may be lost if the plan participant (opposing party) does any of the following **prior to the submission** of the QDRO to the retirement plan administrator:

- Dies
- Becomes disabled
- Quits or is fired
- Retires
- Remarries
- Receives a loan from the plan
- Takes an early withdrawal from the plan

> **Note.** QDROs are a complex legal issue. See an analysis of the *Bougas* TC Memo case on pages 585–586 in the *2003 University of Illinois Federal Tax Workbook* for an example of how inadequate divorce and tax planning cost a divorced individual an avoidable $25,000 IRA early distribution penalty.

DEDUCTIBILITY OF COSTS INCURRED TO GET A DIVORCE

Individuals **cannot** deduct the legal fees and court costs incurred in a divorce. However, parties to a divorce **may deduct the cost of legal fees paid for tax advice regarding the divorce, and for obtaining alimony.** In addition, fees paid to appraisers, actuaries, and accountants for determining the correct tax or for helping to obtain alimony may also be deductible. The important thing to note is that the professional **must separately identify deductible fees** in the bill. The taxpayer cannot allocate the total cost of the divorce to tax-related issues. **The amount and the specific tax issue must be specifically identified in the bill.**

The following billing descriptions illustrate examples of the precise wording necessary to deduct the cost of services performed by a client's divorce attorney:

- Analysis of Separate Maintenance Order to determine deductibility of payments made on behalf of the estranged spouse for income tax purposes
- Review of Child Support Order to determine whether the child qualifies as a dependent and whether a waiver via Form 8332 to release the dependent is required
- Review of marital assets for tax consequences upon subsequent liquidation
- Review of marital assets proposed in the property settlement agreement to determine whether an ex-spouse provided adequate and correct basis information for income tax purposes
- Planning regarding structuring the payment of alimony to ensure it can be deducted for income tax purposes
- Analysis to determine the tax cost of receiving alimony
- Appraisal cost incurred to determine the taxable gain on the eventual sale of property received in the proposed property settlement agreement
- Expert witness fees for testimony regarding the tax cost of property settlement, alimony, or child support

Any deductible fees are reported on line 22 of Schedule A as miscellaneous deductions. They are subject to the 2% of adjusted gross income (AGI) limitation.

PROBLEM 3: MILITARY TAXATION ISSUES

Note. See Chapter 14, New Legislation, for information on the Military Family Tax Relief Act of 2003, including reservists' travel and transportation expenses.

COMBAT PAY EXCLUSION

The combat pay exclusion issue generally poses no tax reporting problem for tax preparers. Excludable combat pay should **not** be included in Box 1 of Form W-2. In the very unusual situation where excludable combat pay is incorrectly included in Box 1 of the Form W-2, the taxpayer or tax preparer must obtain a corrected Form W-2 from the finance office. **A taxpayer cannot exclude any wages shown in Box 1 of Form W-2 as combat pay.** The IRS will disallow an exclusion in arriving at AGI that is claimed on Form 1040 by a statement attached to the return. The only solution to this unusual problem is to obtain a corrected Form W-2.

Note. The combat pay exclusion does not apply to income earned by merchant marine employees who work on a ship owned and operated by the U.S. Navy.[4] Only members of the Armed Forces qualify for the exclusion.

4. *Milton L. Hildebran, et ux. v. Commr.,* TC Memo 2004-42, February 19, 2004

Combat Zone Questions and Answers

Question A. What geographic areas are considered combat zones?

Answer A. There are currently **three** designated combat zones:

1. **Arabian Peninsula Areas.** Beginning January 17, 1991, this area includes the Persian Gulf, Red Sea, part of the Arabian Sea, and the countries of Bahrain, Iraq, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

   As a result of Operation Iraqi Freedom, the following areas were added to the **Arabian Peninsula Areas** combat zone:

   - Turkey, as of January 1, 2003
   - Jordan, as of March 19, 2003
   - Part of the Mediterranean Sea, during the period March 19 through July 31, 2003
   - Israel, during the period January 1 through July 31, 2003
   - Egypt, during the period March 19 through April 20, 2003

2. **Kosovo Area.** Beginning March 24, 1999, this area includes the Federal Republic of Yugoslavia (Serbia and Montenegro), Bosnia and Herzegovina, Croatia, Macedonia, Albania, the Adriatic Sea, and part of the Ionian Sea.

3. **Afghanistan Area.** Beginning September 19, 2001, with the advent of Operation Enduring Freedom, this area includes Pakistan, Tajikistan, Jordan, Incirlik Air Base in Turkey, Kyrgyzstan, Uzbekistan, Yemen, and Djibouti.

Question B. If I am injured and hospitalized while serving in the U.S. Armed Forces in a combat zone, is any of my military pay excluded from gross income?

Answer B. Yes. Military pay received by enlisted personnel who are hospitalized as a result of injuries sustained while serving in a combat zone is excluded from gross income for the period of hospitalization, subject to a two-year limitation.

Commissioned officers have a similar exclusion, limited to the maximum enlisted pay amount per month. For 2003, the monthly combat pay exclusion for officers was limited to $5,957.70. For 2004, the monthly exclusion amount is $6,315.90.

Question C. My son is in the Army and began his assignment in Iraq in January 2004. Is he entitled to an extension of time for filing his 2003 tax return?

Answer C. Yes. There is an automatic minimum 180-day extension for taxpayers who are serving in a combat zone. This extension pertains to:

- Filing tax returns,
- Paying balances due or other deficiencies,
- Filing claims for refund or amended returns,
- Making timely contributions to either a traditional or Roth IRA,
- Making estimated tax payments, and
- Dealing with the IRS and performing certain tax-related actions.

In addition to the 180-day extension, deadlines are also extended by the number of days left to file once combat zone duty begins.

Example 4. Sergeant Sanchez entered Iraq on September 28, 2003. He served in the combat zone through May 23, 2004. He then returned to an army base in the United States. The deadlines for filing his 2003 and 2004 returns are determined as follows.

The 2003 Tax Return. The filing deadline is **March 5, 2005. He has 286 days after leaving the combat zone on May 24, 2004, to file his 2003 tax return.** The computation of the deadline extension period is shown below:

Days from the date he left the combat zone	180
Days remaining to file his 2003 tax return (as of the date he entered the combat zone — January 1 through April 15)	106
Total days in the automatic extension period	**286**

When Sargent Sanchez files his **2003** return, he should write in red at the top of it: "COMBAT ZONE" and his deployment date.

The 2004 Tax Return. The filing deadline is **not** extended because the 180-day extension period after May 23, 2004, ends on November 19, 2004. Obviously, this is before the start of the filing season for 2004 returns (January 1 through April 15, 2005). Therefore, he must file his 2004 return by April 15, 2005 unless he applies for the normal filing extensions.

Question D. How will the combat pay exclusion affect the computation of the Earned Income Tax Credit (EITC)?

Answer D. A change in the law for **2002 and later years** removes all employee compensation excluded from gross income from the definition of "earned income." Therefore, excludable combat pay, the Basic Allowance for Housing (BAH), and the Basic Allowance for Subsistence (BAS) no longer qualify as earned income for EITC purposes. Depending on the circumstances, this change may either increase or decrease the amount of EITC allowable compared to the amount of the credit allowable on 2001 and earlier returns with the same facts.

Question E. My husband is serving in Iraq. He won't return home until sometime in the summer of 2005. He failed to send me a power of attorney. Can I sign his name for him on our joint 2004 return? We have a large refund and I need the money.

Answer E. Yes. Attach a signed statement to your joint 2004 return that explains that your husband is serving in a combat zone.

MILITARY PAY, INCLUDABLE AND EXCLUDABLE

See Tables A and B from IRS Pub. 3, *Armed Forces' Tax Guide*.

IRS Pub. 3, *Armed Forces Tax Guide*

Table A. **Included Items**

These items are included in gross income, ***unless*** the pay is for service in a combat zone.

Basic pay	• Active duty • Attendance at a designated service school • Back wages • Drills • Reserve training • Training duty	**Bonuses**	• Career status • Enlistment • Officer • Overseas extension • Reenlistment
Special pay	• Aviation career incentives • Career sea • Diving duty • Foreign duty (outside the 48 contiguous states and the District of Columbia) • Foreign language proficiency • Hardship duty • Hostile fire or imminent danger • Medical and dental officers • Nuclear-qualified officers • Optometry • Overseas extension • Pharmacy • Special duty assignment pay • Veterinarian	**Other payments**	• Accrued leave • High deployment per diem • Personal money allowances paid to high-ranking officers • Student loan repayment from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone • CONUS COLA
		Incentive pay	• Submarine • Flight • Hazardous duty • High altitude/Low altitude (HALO)

Table B. **Excluded Items**

The exclusion for certain items applies whether the item is furnished in kind or is a reimbursement or allowance. There is no exclusion for the personal use of a government-provided vehicle.

Living allowances	• BAH (Basic Allowance for Housing). You can deduct mortgage interest and real estate taxes on your home even if you pay these expenses with your BAH • BAS (Basic Allowance for Subsistence) • Housing and cost-of-living allowances abroad whether paid by the U.S. Government or by a foreign government • OHA (Overseas Housing Allowance)	**Combat zone pay**	• Compensation for active service while in a combat zone or a qualified hazardous duty area. Note: Limited amount for officers
		Family allowances	• Certain educational expenses for dependents • Emergencies • Evacuation to a place of safety • Separation
Moving allowances	• Dislocation • Military base realignment and closure benefit paid after November 11, 2003 (the exclusion is limited as described on page 5) • Move-in housing • Moving household and personal items • Moving trailers or mobile homes • Storage • Temporary lodging and temporary lodging expenses	**Death allowances**	• Burial services • Death gratuity payments to eligible survivors • Travel of dependents to burial site
		Other payments	• Defense counseling • Disability, including payments received for injuries incurred as a direct result of a terrorist or military action • Group-term life insurance • Professional education • ROTC educational and subsistence allowances • Survivor and retirement protection plan premiums • Uniform allowances • Uniforms furnished to enlisted personnel
Travel allowances	• Annual round trip for dependent students • Leave between consecutive overseas tours • Reassignment in a dependent restricted status • Transportation for you or your dependents during ship overhaul or inactivation • Per diem	**In-kind military benefits**	• Dependent-care assistance program • Legal assistance • Medical/dental care • Commissary/exchange discounts • Space-available travel on government aircraft

PROBLEM 4: RESIDENCE TAX ISSUES

RENTAL OF PORTION OF RESIDENCE TO TAXPAYER'S TRADE OR BUSINESS

Background Information

The **self-rental rule** of Treas. Reg. §1.469-2(f)(6) continues to be a frequently raised issue in IRS examinations. This rule recharacterizes activities reasonably considered passive as nonpassive activities. The Passive Activity Losses MSSP Audit Guide specifically alerts IRS examiners to consider this issue in their examinations.

> **Note.** See **Problem 7** in this chapter for more information regarding the IRS MSSP (Market Segment Specialization Program) Audit Guide for Passive Activity Losses.

Treas. Reg. §1.469-2(f)(6) The Self-Rental Rule

The regulation states:

An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as ***not from a passive activity*** *if the property is rented for use in a trade or business activity in which the taxpayer* ***materially participates*** *(within the meaning of Temp. Treas. Reg. §1.469-5T) for the taxable year.*

In essence, this regulation provides that when a taxpayer rents property to his own business, the rental profit is not treated as passive activity income.

The facts in the following example were taken from a recent TC Memo case.[5]

Facts. The taxpayers, husband and wife, owned five apartment buildings which each reported net rental losses on their Schedule E. The taxpayers also wholly owned two auto interior repair C corporations. Both of the taxpayers were full-time employees of their two corporations. During the year in question, the taxpayers rented a portion of their personal residence to the C corporations. Both C corporations paid substantial amounts of rent to the taxpayers for using a portion of their residence as the business offices of the corporations.

During 1999, the taxpayers reported a net rental profit of approximately $22,000 on their Schedule E for renting a portion of their residence to the corporations. **On their individual tax return, the taxpayers reported all six rental properties on their 1999 Schedule E as follows:**

Total of net rental losses for the 5 apartment buildings (assumed from given facts)	($65,000)
Net rental profit from renting part of their residence to the two C corporations	22,000
Schedule E net loss reported but not deducted due to Form 8582 limitations	**($43,000)**

In its examination, the IRS held that the self-rental rule applied and reclassified the $22,000 rental profit as non-passive income. Thus, the $22,000 rental profit could not be used to offset the $65,000 loss on the rental of the other five rental properties. **The tax result, according to the IRS, was:**

- The $22,000 nonpassive profit from renting a part of their residence was taxable.
- The $65,000 net rental loss on the other five rental properties was a **nondeductible passive loss** since the taxpayers' modified AGI exceeded the $150,000 limitation for the Special Allowance for Rental Real Estate (shown in Part II, Form 8582, Passive Activity Loss Limitations). The $65,000 loss was treated as a **suspended** passive loss.

5. *Cal Interiors Inc. v. Commr.*, TC Memo 2004-99, April 7, 2004

Holding. The court agreed with the IRS position and restated the opinion it had reached in five previous Tax Court decisions that found the self-rental regulation was valid.

Conclusion

The Tax Court and three Courts of Appeal, namely the 1st, 5th, and 7th Circuits (which include IL, IN, and WI), have consistently ruled that the self-rental rule is valid. There has been no successful court challenge to the validity of the regulation. The result is that there is no adequate authority for preparers to ignore the regulation.

> **Note.** See pages 308–310 in the *2001 University of Illinois Farm Income Tax Workbook* for more details on this issue, including a correctly and an incorrectly completed Form 8582, Passive Activity Loss Limitations.

Observation. The Tax Court transcript did not give details regarding another potential aspect of the case, which is the **limitation on home expenses when an employee rents a portion of his home to his employer.** The limitation of **IRC §280A(c)(6)** is explained in IRS Pub. 587, *Business Use of Your Home,* as follows:

Rental to employer. *If you rent part of your home to your employer and you use the rented part in performing services for your employer as an employee, your deduction for the business use of your home is limited. You can deduct mortgage interest, real estate taxes, and personal casualty losses for the rented part, subject to any limitations. However, you cannot deduct otherwise allowable trade or business expenses, business casualty losses, or depreciation related to the use of your home in performing services for your employer.*[6]

CALCULATING THE HOME OFFICE DEDUCTION

A recent TC Memo case[7] demonstrates the need to carefully prepare Schedule Cs that report net losses.

Facts. The taxpayer reported a Schedule C net loss of $8,600 after claiming a home office deduction of $10,600, consisting entirely of rent paid. Included in the cost of goods sold was $3,400 for the cost of a business computer. In its examination, the IRS:

- Disallowed the portion of the claimed home office deduction that exceeded the tentative profit (Schedule C, line 29), and
- Disallowed the cost of the computer because the required IRC §179 expense election was not made on Form 4562.

Observation. Many wage earners also have sideline businesses. In many cases, these part-time businesses are not profitable. When preparing returns for these taxpayers, pay close attention to the limitation on claiming home office expenses. **A deduction for the home office portion of insurance, utilities, repairs, and depreciation cannot create or increase a net Schedule C loss.** In addition, a quick analysis of repairs might identify a capital asset for which the IRC §179 expense election is required.

> **Caution.** One area of abuse of the EITC involves wage earners claiming inflated Schedule C losses in order to reduce AGI to the level where EITC can be claimed.

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6. Excerpt from IRS Pub. 587

7. *Michael H. Visin v. Commr.*, TC Memo 2003-246, August 18, 2003

LIMITATION ON DEDUCTING HOME EQUITY DEBT

Background Information

With the large increase in home values, many taxpayers are cashing in on the increased value to obtain home equity debt. Home equity debt is any debt secured by a qualified residence, other than "acquisition debt," to the extent such debt does not exceed:

- The fair market value (FMV) of the residence, reduced by
- The amount of the current acquisition debt on the residence.

In addition, the aggregate amount of home equity debt for any period may not exceed $100,000 ($50,000 for a married taxpayer filing separately).[8]

Many self-employed taxpayers use home equity loans to finance their business operations. If these loans are used for business purposes, the taxpayer may need an election to treat the debt as **not** secured by the residence.[9] This is true if the combined total of home equity debt exceeds the $100,000 limitation. Although this election is often ignored, it is important to consider in order to allow remaining interest as a deduction on Schedule A.

Example 5. Carol is a self-employed interior decorator. She owns a residence which has an FMV of $300,000. It currently is subject to an original mortgage with an outstanding balance of $100,000. On July 1, 2004, she receives two home equity loans as shown below.

Loan Proceeds Used For	Amount of Home Equity Loan
Swimming pool improvement to residence	$ 45,000
Purchase of building for business to replace rented property	130,000
	$175,000

Question A. Carol pays $1,000 of interest on the $45,000 swimming pool loan in 2004. The lender provides a 2004 Form 1098 for the $1,000 of interest payment. Where is the $1,000 interest expense deducted on her 2004 tax return?

Answer A. On Schedule A, line 10 (home mortgage interest and points reported to you on Form 1098).

Question B. Carol pays $3,000 of interest on the $130,000 business building loan. The lender provides a 2004 Form 1098 for the $3,000 interest payment. Where is the $3,000 interest expense deducted on her 2004 return?

Answer B. On Schedule C, line 16b (other interest).

Question C. Should Carol attach an election to her 2004 return?

Answer C. The technical answer is **yes**. The $130,000 home equity loan is "qualified residence interest" under IRC §163(h)(2)(d). Since Carol's total home equity indebtedness exceeds the $100,000 limitation in 2004, she should attach an election to remove the $130,000 debt from the limitation. A sample election is shown for Carol.

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8. IRC §163(h)(3)(C)

9. Temp. Treas. Reg. §1.163-10T(o)(5)

Election under Temp. Treas. Reg. §1.163-10T(o)(5)

I received a $130,000 home equity loan in 2004 which I used for my business, Dream Home Interior Decorators. I elect to treat the $3,000 of interest on this loan as trade or business debt. The $3,000 interest is included in the total for line 16b on my 2004 Schedule C.

HOME REFINANCING

When interest rates decline, many homeowners refinance their existing home mortgages. The advent of **no closing cost** loans has made refinancing more attractive to some homeowners. From a planning standpoint, no closing cost refinancing loans usually carry a slightly higher interest rate, about half of a percentage point.

One key factor for those who consider refinancing is the estimated time they will reside in their home. Those who expect to remain in their homes for 10 years or more might be wise to choose a lower-rate loan with points over a no closing cost loan with a higher rate. Many fixed-rate refinancing loans charge no points but do charge closing costs such as appraisal and "document" fees.

Home Refinancing Mortgages That Charge Points

Following is a list of the tax rules that apply to home refinancing mortgages that charge points:

1. Points paid on a refinanced mortgage are usually not fully deductible in the year paid.
2. **An exception** applies if a **portion** of the refinanced mortgage proceeds is used to **improve** a principal residence. Points attributable to improvement costs may be deducted in the year paid.
3. Points that are not currently deductible must be prorated and deducted over the life of the refinanced loan.
4. Deductible points that are not reported on Form 1098 are entered on Schedule A, line 12.
5. Deductible points reported on Form 1098 are entered on Schedule A, line 10.
6. If a refinanced loan is paid off early, the remaining points are deducted in the year the mortgage is paid off. (However, if the loan is paid off with a refinancing by the same lender, the remaining points are spread over the term of the new loan.)
7. Amounts charged by lenders for specific services connected to the loan are not deductible, assuming the home is used only for personal purposes. Examples are:
   - Appraisal fees
   - Attorney fees
   - Recording fees
   - Document fees

Example 6. Gary and Joan bought their principal residence in 2000 for $125,000. They financed $115,000 of the purchase with a 30-year fixed-rate mortgage at an 8% interest rate. They refinanced the old mortgage in 2004. Following are the facts regarding the refinanced mortgage:

Date of refinancing	May 1, 2004
Type of mortgage	30-year fixed
Principal amount refinanced	$110,000
Interest rate	6%
Points paid (1% of $110,000)	$1,100
Amount of loan proceeds used to improve home	None
Date of first payment on the refinanced mortgage	June 1, 2004
Amount of points reported on the 2004 Form 1098	None

Question. Can Gary and Joan deduct any of the $1,100 points they paid on their 2004 Schedule A?

Answer. Yes. The prorated deduction is **$21 (rounded),** computed as follows:

$1,100 points ÷ 360 monthly payments = $3.06 per month

$3.06 × 7 payments in 2004 = $21.42

The $21 deduction will be entered on Schedule A, line 12 (points not reported on Form 1098).

Example 7. Use the same facts as **Example 8** except, the amount of the refinanced mortgage is $140,000. The extra $30,000 of loan proceeds are used to add a deck and back porch to their home. Gary and Joan use the remaining $110,000 to repay the original mortgage balance. Following are the facts regarding the refinanced mortgage:

Points paid (1% of $140,000)	$ 1,400
Amount of loan proceeds used to improve home	30,000
Amount of points reported on 2004 Form 1098 (1% of $30,000)	300

Question. What amount of points are deductible on their 2004 Schedule A?

Answer. $321 ($300 reported on Form 1098 + $21 not reported on Form 1098).

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

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
2004
Attachment Sequence No. 07

Name(s) shown on Form 1040: **Gary and Joan**
Your social security number

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

	9	Add lines 5 through 8		9	
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10 300 00		
	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 21 00		
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)	13		
	14	Add lines 10 through 13		14	321 00
	15	Gifts by cash or check. If you made any gift of $250 or			

Example 8. Use the same facts as **Example 9**. Joan receives a large inheritance from her uncle in **2005** and they pay off the entire refinanced mortgage in **2005**. The interest reported on the 2005 Form 1098 for the refinanced mortgage is $5,500.

Question. What is the total deduction for points and interest on their 2005 Schedule A?

Answer. **$6,579** as calculated.

Interest reported on the 2005 Form 1098	$5,500
Balance of points not deducted in 2004 ($1,400 – $321 deducted in 2004)	1,079
	$6,579

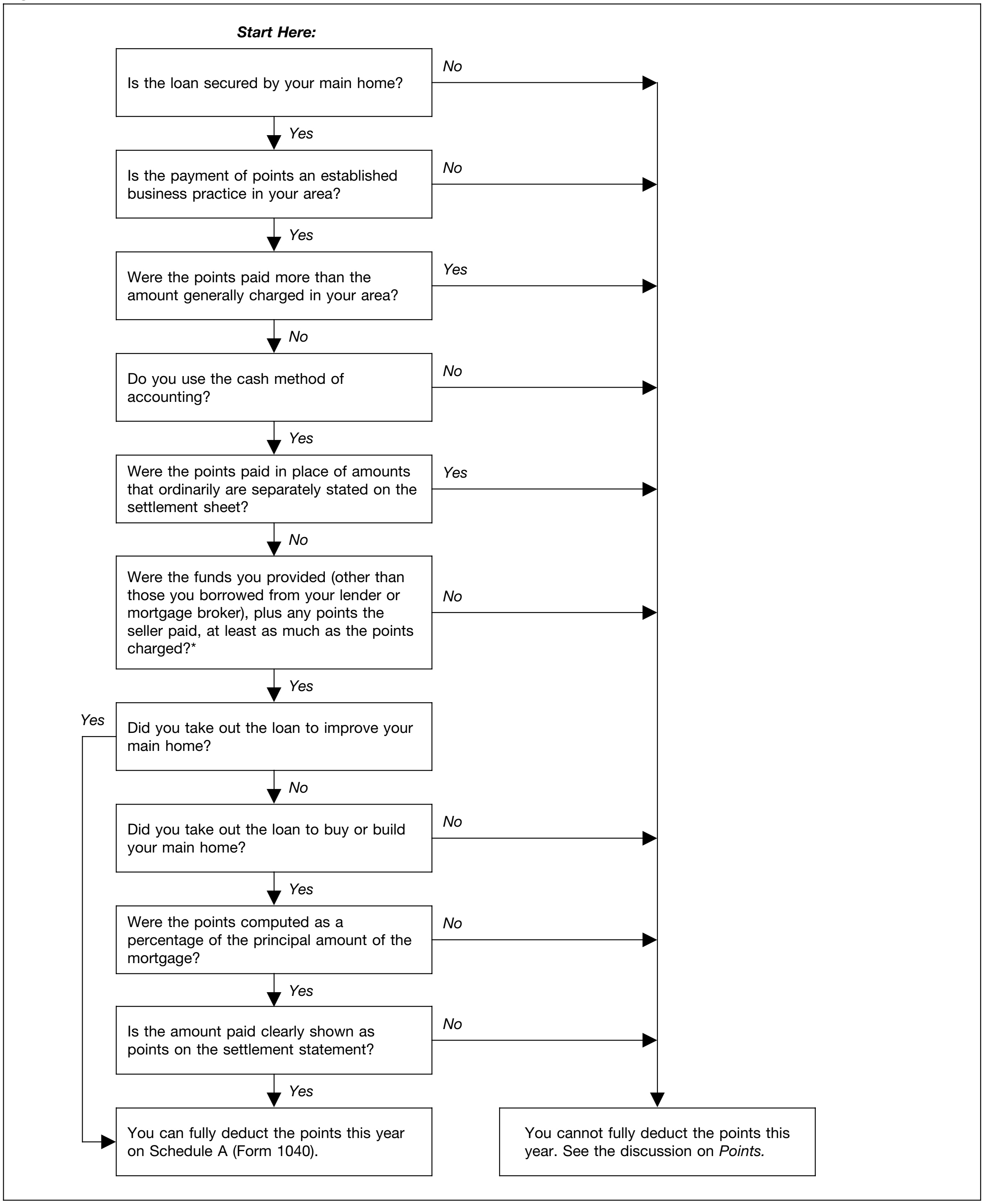
Practitioner Alert. Taxpayers who reside in the **8th Circuit** (includes AR, IA, MN, MO, NE, ND and SD) are allowed to deduct points on a refinancing home loan if a long-term refinancing mortgage replaces a short-term original home loan.[10] In the *Huntsman* case, they replaced the original three-year balloon loan with a 30-year variable rate mortgage.

10. *James and Zenith Huntsman v. Commr.*, 905 F.2d 1182, 8th Cir. Ct. of Appeals, 90-2 USTC ¶50,340, June 14, 1990

Figure B from IRS Pub. 936, *Home Mortgage Interest Deduction* is reprinted here.

IRS Pub. 936, *Home Mortgage Interest Deduction*

Figure B. **Are My Points Fully Deductible This Year?**



* The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.

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PROBLEM 5: CONTINGENT ATTORNEY FEES UPDATE

GENERAL INFORMATION

With the continuing flood of age, race, and gender discrimination and sexual harassment lawsuits, tax preparers may encounter clients who receive significant court awarded settlements. Since the 1995 Supreme Court decision in *Commissioner v. Schleier,*[11] these types of judgment awards are generally **not** excludable from gross income.

IRC §104(a)(2) states:

Gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

In addition, the code section further states that **"emotional distress shall not be treated as a physical injury or physical sickness."**

The tax result is that judgments received after August 20, 1996, for **nonphysical personal injury or sickness** are includable in gross income. Examples of these (not all inclusive) are:

- Employment discrimination (age, race, gender),
- Wrongful termination of employment,
- Defamation of character (libel/slander),
- Alienation of affections,
- Wrongful prosecution, and
- Breach of contract (including business disputes).

CONTINGENT ATTORNEY FEES

The taxpayer's state of residence determines whether her contingent attorney fees are includable in her gross income, because courts are split on this issue. The table that follows combines judicial positions and IRS recaps of the decisions as of May 2004 (see the introduction to Chapter 13, Rulings and Cases, for the jurisdiction of the various courts listed).

Includable in Gross Income	Excludable from Gross Income
Internal Revenue Service	5th Circuit Ct. of Appeals
Tax Court	6th Circuit Ct. of Appeals
1st Circuit Ct. of Appeals	11th Circuit Ct. of Appeals
2nd Circuit Ct. of Appeals	
3rd Circuit Ct. of Appeals	
4th Circuit Ct. of Appeals	
7th Circuit Ct. of Appeals	
9th Circuit of Appeals*	
10th Circuit Ct. of Appeals	
Federal Circuit Ct. of Appeals	

*The 9th Circuit is split depending on which state the taxpayer resides in. For those who reside in California or Alaska, the fees are includable. For those who reside in Oregon, the fees are excludable.

11. *Commr. v. Erich E. and Helen B. Schleier,* 115 SCt. 2159, 95-1 USTC ¶50,309, June 14, 1995

There are two lines of reasoning in the conflicting court decisions:

1. **The assignment of income doctrine allows including contingent fees in the gross income of the taxpayer.** This doctrine, established by the Supreme Court in 1930, holds that **taxpayers cannot assign the income that they are legally entitled to receive over to a third party without first paying tax on it**. The Tax Court applied this doctrine to contingent attorney fees in *Kenseth v. Commissioner*.[12]

> **Note.** The nine majority Tax Court judges in the *Kenseth* decision held that the state lien statutes are irrelevant. The "shotgun" approach of IRC §61 controls and the assignment of income doctrine must be applied. "Gross income means all income from whatever source derived."[13] See pages 630–631 in the *2000 University of Illinois Farm Income Tax Workbook* for an analysis of this important decision. The 7th Circuit Court of Appeals, which includes Illinois, Indiana, and Wisconsin, affirmed the Tax Court's decision in 2001.

2. **Attorneys must examine state law** to determine if they have a superior lien or ownership right to their clients' judgments. **If they do not**, **the contingent fee is part of the client's gross income.** See *Coady v. Commissioner,*[14] discussed on pages 629–630 in the *2000 University of Illinois Farm Income Tax Workbook*. In *Coady*, Alaskan state law did **not** grant a superior lien to attorneys. Therefore, the contingent fee was **includable** in the gross income of the taxpayer-client. The 9th Circuit relied upon a similar rationale in *Banaitis* to arrive at an opposite decision in favor of the taxpayer.[15]

Update as of August 2004

In March 2004, the Supreme Court announced that it agreed to settle the controversy created by the split in the Federal Circuit Courts of Appeal over this tax issue. The Supreme Court will review the *Banaitis* and *Banks II*[16] cases, both of which were decided in favor of the taxpayer, in holding that the contingent fees were **excludable** from gross income.

> **Note.** See an analysis of the *Banks* 6th Circuit case in the Gross Income section of Chapter 13, Rulings and Cases.

Tax Complications of Including Contingent Attorney Fees in Gross Income

There are tax complications for including contingent attorney fees paid by the taxpayer in his gross income. Following is a list of these complications:

1. The contingent attorney fees are a miscellaneous itemized deduction, subject to the 2% of AGI floor.
2. The contingent attorney fees are also subject to the 3% of AGI reduction rules for itemized deductions claimed by high-income taxpayers. In most cases, successful litigants are high-income taxpayers in the year the judgment is paid.
3. Miscellaneous itemized deductions are not deductible for alternative minimum tax (AMT) purposes. This can result in significant AMT liability for the taxpayer in the year the judgment is received and the legal fees are paid.

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12. *Eldon R. and Susan M. Kenseth v. Commr.,* 114 TC 399, May 24, 2000

13. IRC §61(a)

14. *Franklin P. and Nona Coady v. Commr.,* 213 F.3d 1187, 1190-91, 2000-1 USTC ¶50,528, June 14, 2000

15. *Sigitas Banaitis v. Commr.,* 340 F.3d 1074, 2003-2 USTC ¶50,638, August 27, 2003

16. *John W. Banks II v. Commr.,* 345 F.3d 373, 2003-2 USTC ¶50,675, September 30, 2003

The following facts are taken from ***Kenseth*****. The amounts shown are the results reached in an IRS exam upheld by both the Tax Court and the 7th Circuit Court of Appeals.**

> **Note.** Mr. Kenseth successfully sued his former employer for age discrimination when his job was terminated.

Total judgment received by taxpayer in 1993	$229,000
Contingent fee paid directly to taxpayer's attorney (40%) by the defendant/employer	(92,000)
Net amount retained by taxpayer before taxes	**$137,000**
Amount of contingent fee deductible on Schedule A after the 2% of AGI floor and the 3% of AGI reduction for high-income taxpayers	82,000
AMT liability created by the $82,000 Schedule A deduction (not deductible for AMT purposes)	17,000
Additional regular tax owed by including the contingent fee	38,000
Total additional tax owed on the 1993 Form 1040	**$ 55,000**

Therefore, Mr. Kenseth retained $82,000 ($137,000 – $55,000) of the $229,000 judgment on an after-tax basis. This $82,000 retention figure ignores any nondeductible interest he paid to the IRS on his $55,000 tax deficiency.

Observation

This is a difficult issue for preparers. Since the IRS is becoming more vigorous in its enforcement, this area is a logical one for selected IRS exam projects. Both the IRS and Tax Court agree on the inclusion of contingent fees in the gross income of successful litigants. The Supreme Court will soon settle this divided tax issue.

> **Note.** Due to many disputes with taxpayers over the issue of taxability of lawsuit settlements, the IRS released a new publication. It is Pub. 4345, *Settlements Taxability.* Where to report taxable settlements and court awards on the tax return is one issue addressed in the publication. However, the publication is silent regarding the correct tax treatment of contingent attorney fees.

PROBLEM 6: TAX PLANNING UNDER JGTRRA OF 2003

The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 provided a host of tax planning opportunities for taxpayers and their tax advisors. This problem analyzes some of these opportunities.

LOWER LONG-TERM CAPITAL GAIN TAX RATES

In general, taxpayers from the 25% or higher tax bracket in 2004 pay a maximum 15% tax rate on long-term gains. Many of these taxpayers may be tempted to benefit from the extremely low 15% rate and sell the appreciated capital assets that they have held for many years.

Another dilemma facing many taxpayers is the large capital loss carryover to 2004 from stock and bond losses they have taken in recent years. However, some of these taxpayers might have other long-term capital assets to sell in 2004 to offset the carryover. If so, the resulting gain from 2004 sales of these assets could be entirely or partially tax free.

Example 9. Jim is single. He has a $95,000 long-term capital loss carryover to 2004. He also has a realized net short-term capital gain of $15,000 on stock trades this year.

Jim inherited 100 acres of central Illinois farm ground from his father in 1990. Since his father's estate utilized the IRC §2032A lower use valuation to value the 100 acres, Jim's basis in the farmland is only $700 per acre.

Jim lives in Colorado and he has neither the time nor the farm expertise to properly manage the land. His accountant informed Jim about the generous increase in value in his land.

Tax Solution for Example 9. Jim sells the farmland in 2004. His gain is computed as follows:

Sales price (100 acres $4,500 per acre)	$450,000
Less: Expenses of sale	(15,000)
Less: Basis (100 acres $700 per acre)	(70,000)
Jim's long-term capital gain on the land	**$365,000**

2004 Tax Result for Jim. His 2004 Schedule D will show the following:

Realized short-term gain on stock trades	$ 15,000
Long-term gain on sale of inherited land	365,000
Long-term capital loss carryover to 2004	(95,000)
Net long-term capital gain	$270,000

Jim's 2004 marginal tax bracket is 35%, the highest for a single taxpayer. Jim's regular tax liability on his 2004 Schedule D transactions is:

Tax on the $15,000 net short-term gain (35% × $15,000)	$ 5,250
Tax on the $270,000 net long-term gain (15% × $270,000)	40,500

Observations for Example 9

1. Due to the capital loss carryover, only $270,000 of the $365,000 long-term gain on the sale of the farmland is taxable, resulting in only $40,500 of tax. **$40,500 ÷ $365,000 = an effective tax rate on the gain on the sale of the land of only 11%.**

2. It is possible that Jim will have an AMT liability in 2004 due to the large long-term capital gain from selling the 100 acres. If so, the 11% effective tax rate shown in #1 will be higher. **AMT is a planning factor Jim's tax preparer must consider before Jim makes the decision to sell his land.**

> **Note.** See page 553 in the *2003 University of Illinois Federal Tax Workbook* for a brief analysis of why high-income taxpayers with large long-term capital gains could owe AMT.

3. An **IRC §1031 tax-deferred exchange** is another tax planning possibility for Jim. He could exchange the 100 acres for an apartment building.

4. Another potential solution to Jim's problem is to let an experienced farm manager make all decisions and keep proper tax records regarding the 100 acres. However, that decision will have little impact on his desire to use his capital loss carryover in a tax-efficient manner.

5. With the trend for central Illinois farmland to appreciate in value, **Jim may be wise to keep the 100 acres and sell it later.** However, tax law can change at any time. There is **no guarantee** that the low 15% tax rate on long-term gains for high-income taxpayers is permanent.

> **Note.** The **lower 15% or 5%** (for taxpayers in the 10% or 15% tax brackets) tax rates on qualified dividends and long-term capital gains are **scheduled to expire beginning in 2009.** These favorable tax rates could be raised at that time, or even earlier, depending on the whims of Congress.

6. In addition to farmland, there are many other types of long-term capital assets that Jim could sell at a gain to offset his $95,000 capital loss carryover to 2004. They include, but are not limited to:

- Stock of a closely-held corporation,
- Country club membership,
- Principal residence, if the gain exceeds the $250,000/500,000 exclusion limits,
- Vacation home that does not meet the principal residence tests,
- Rental real estate building, including that owned by a flow-through entity such as a partnership. However, any unrecaptured §1250 gain is generally taxed at a 25% rate rather than a 15% rate, and
- Ownership interest in a partnership or limited liability company.

Example 10. Mary is an 85-year-old widow who is in relatively good health. However, she is concerned that she may someday have to enter a nursing home and wonders how she will pay for it if she does. She has no long-term care insurance coverage. She has relatively high net worth consisting mainly of low-basis IBM stock inherited from her husband in 1975. Her projected 2004 taxable income is $19,000 with no sales of IBM stock. That scenario will place her in the 15% tax bracket.

Tax Solution for Example 10. It would probably make tax sense for Mary to make systematic sales of some of her low-basis IBM stock in the years 2004 through 2008. **Assume Mary decides to sell sufficient shares of IBM to create a $50,000 long-term gain in each of the years 2004–2008.** Her projected 2004 taxable income of $19,000 is below the $29,050 ceiling for the 15% tax bracket for single taxpayers. The tax result is as follows:

- A portion of her $50,000 gain on IBM stock is taxed at only 5%. Based on given facts, that portion is $10,050 ($29,050 – $19,000). The tax liability on the $10,050 portion is **$503** ($10,050 × 5% = $503).
- The balance of the 2004 gain is taxed at 15%. That balance is $39,950 ($50,000 total gain – $10,050 taxed at 5%). The tax liability on the $39,950 balance is **$5,992** ($39,950 × 15% = $5,992).
- Mary's total federal tax cost of selling enough IBM stock to generate a $50,000 gain is only $6,495 ($503 + $5,992). The sales price of her stock is $60,000. Her state income tax rate on the gain is 3%. **By selling the stock, she nets $52,005 to apply towards potential nursing home expenses, as shown in the computation below.**

Sales price of IBM stock	$60,000
Less federal tax on the $50,000 gain	(6,495)
Less state income tax on the $50,000 gain	(1,500)
Amount of after-tax dollars Mary keeps	$52,005

Observations for Example 10

1. Mary's effective total tax rate (federal and state) on her $50,000 gain is only 16% ($7,995 total tax ÷ 50,000 gain).

2. Mary can invest the $52,005 after-tax proceeds of the sale into a CD or bond that pays a much higher interest rate than IBM's dividend yield. As of May 25, 2004, IBM common stock paid a dividend equal to slightly less than 1% of the price per share (.81% or .008).

3. If Mary does not have to enter a nursing home before she dies, a better decision might be to sell none of her IBM stock. Then her children or grandchildren could inherit it with a stepped-up basis. However, her heirs are more likely to be in the 25% tax bracket or higher if and when they sell the inherited stock. If they are, they will not be able to take advantage of the 5% capital gains tax rate available to Mary on a portion of her gain on the sale of the stock.

4. Whether the suggested tax solution for **Example 10** is a wise decision depends on:
   - Whether the price of IBM rises significantly in the future,
   - If and when Mary must enter a nursing home, and
   - Whether the tax rates on long-term gains are raised before 2009.

Example 11. Dale is age 65 and single in 2004. He made an installment sale of a two-unit apartment building on December 1, 2001. Dale constructed the building in 1970. **The details of the 2001 installment sale are shown below.**

Sales price (contract date was Dec. 1, 2001)		$160,000
Construction cost	$30,000	
Cost of lot	5,000	
Dale's total cost in the building (no improvements made)	$35,000	
Plus: Expense of sale	1,000	
Cost plus expense of sale	$36,000	
Less: Straight-line depreciation using a 30-year life	(30,000)	
Adjusted basis at time of sale		(6,000)
Dale's total gain shown in Part III on his 2001 Form 4797		**$154,000**
Gross profit percentage shown on the 2001 Form 6252 ($154,000 ÷ $160,000)		**96.25%**

The $160,000 sales price was to be paid as follows:

1. $10,000 down in December 2001, the year of sale.
2. $150,000 balance payable monthly over 20 years at 7% interest.
3. 2002 principal payments received by Dale were $3,570 (taxable amount was $3,436)
4. 2003 principal payments received by Dale were $3,830 (taxable amount was $3,686)

Dale's unrecaptured §1250 gain of $30,000, which is taxed at a 25% maximum rate, must be reported first, before the remaining §1231 gain of $124,000.

Total gain on the sale	$154,000
Less unrecaptured §1250 gain	(30,000)
Remaining §1231 gain eligible for the lower 5% or 15% tax rates	$124,000

Remaining unrecaptured §1250 gain to be reported in 2004 and later years is:

Total unrecaptured §1250 gain to be reported	$30,000
Reported in 2001 ($10,000 down payment × 96.25% gross profit percentage)	(9,625)
Reported in 2002 ($3,570 × 96.25% gross profit percentage)	(3,436)
Reported in 2003 ($3,830 × 96.25% gross profit percentage)	(3,686)
Remaining unrecaptured §1250 gain to be reported in 2004 and later years	**$13,253**

Dale's **2004** gross income will consist of the following if the buyer makes the scheduled installment sale payments:

$14,000 of social security benefits

$4,000 of taxable principle payments from Form 6252, line 26, *Installment Sale Income*

$9,850 of interest income from the buyer

Example 12. Use the same facts as **Example 11** except, the buyer of the apartment building wants to pay off the outstanding principal balance on January 1, 2004, due to a decrease in interest rates. The outstanding principal balance is $142,600 at the end of 2003.

Question A. What are the **advantages** to Dale if he permits the buyer to pay off the entire principal balance on January 1, 2004?

Answer A. The biggest tax advantage is that $9,861 of the taxable principal balance will be taxed at the 5% tax rate, as shown in **Example 14** on the next page. Another advantage is that Dale doesn't have to worry about the buyer defaulting on her installment sale obligation in the future.

Question B. What are the **disadvantages** to Dale if the buyer pays off the entire principal balance in 2004?

Answer B. There are several disadvantages including:

- Dale will have a significant 2004 tax liability of $20,013. He will not owe AMT for 2004.
- 85% of Dale's $14,000 social security benefits will be taxable.
- Instead of receiving a 7% interest rate from the buyer on the unpaid principal balance, Dale will receive a much smaller interest rate, assuming he reinvests the $142,600 payoff in a money market account.

Example 13. Use the same facts as **Example 11.** Dale does **not** permit the installment buyer to pay off the entire principal balance of $142,600 on January 1, 2004. None of Dale's social security benefits are taxable. His 2004 taxable income is $4,700.

Unrecaptured IRC §1250 gain	$ 4,000
Interest paid by buyer	9,850
AGI	$13,850
Less exemption	(3,100)
Less standard deduction	(6,050)
Taxable income	$ 4,700

Dale's tax liability is $470, as calculated on the Schedule D Tax Worksheet (not shown). Due to Dale's low 2004 taxable income of $4,700, the entire $4,000 of unrecaptured IRC §1250 income is taxed at a 10% rate. **It is not taxed at the maximum 25% rate.**

Example 14. Dale permits the installment buyer to pay off the entire principal of $142,600 on January 1, 2004. Dale's 2004 taxable income of $143,189 includes 85% of his social security benefits. Computation of Dale's 2004 taxable income follows:

Balance of unrecaptured IRC §1250 gain	$ 13,253
Entire IRC §1231 gain	124,000
Interest income on 2% money market account purchased with the $142,600 principal balance received on Jan. 1, 2004	3,000
Taxable social security benefits ($14,000 × 85%)	11,900
Adjusted gross income	$152,153
Less exemption (partial phaseout applies)	(2,914)
Less standard deduction	(6,050)
Dale's 2004 taxable income	$143,189

Dale's tax liability is $20,013, as calculated on the 2004 Schedule D Tax Worksheet (which is shown on the next page). His tax liability calculation is:

$9,861 of the $124,000 IRC §1231 gain is taxed at a 5% rate. $9,861 × 5% =	$ 493
$114,139 of the $124,000 IRC §1231 gain is taxed at a 15% rate. $114,139 × 15% =	17,121
Tax on the $19,189 balance of his $143,189 taxable income is calculated using the 2004 Tax Table for single taxpayers. Tax Table amount is:	2,519
Dale's 2004 tax liability is:	**$20,133**

Observations for Example 14

1. **In Example 14, the $13,253 remaining balance of the unrecaptured IRC §1250 gain is not taxed at the maximum 25% rate.** The $13,253 is included in the $19,189 balance of taxable income figure shown above. The Tax Table amount of $2,519 on the $19,189 balance results from a blending of the 10% and 15% tax rates ($2,519 ÷ $19,189 = a blended 13.12% tax rate).

2. Whether Dale should agree to permit the buyer to pay off the $142,600 principal balance on January 1, 2004, depends on many factors. However, the lower capital gain tax rates of 5% and 15% are great incentives for Dale to accept a 2004 principal balance payoff.

3. In **Example 14,** the $17,614 ($493 + 17,121) of tax on the $124,000 §1231 gain results in an effective tax rate of only 14.2 % ($17,614 ÷ 124,000).

4. The new lower 5% and 15% capital gain tax rates apply to payments received on or after May 6, 2003, on existing installment sale contracts of assets which qualify for long-term capital gain treatment.

5. Unrecaptured IRC §1250 gain is taxed at a **maximum** 25% tax rate. However, if the taxpayer's top tax rate is less than 25%, the unrecaptured §1250 gain is taxed at lower tax rates.

For Example 14

Schedule D Tax Worksheet (from 2004 Form 1040 Instructions)

Keep for Your Records

Complete this worksheet only if line 18 or line 19 of Schedule D is more than zero. Otherwise, complete the Qualified Dividends and Capital Gain Tax Worksheet on page xx of the Instructions for Form 1040 to figure your tax.

Exception: Do not use the Qualified Dividends and Capital Gain Tax Worksheet **or** this worksheet to figure your tax if:
- Line 15 or line 16 of Schedule D is zero or less **and** you have no qualified dividends on Form 1040, line 9b, **or**
- Form 1040, line 42, is zero or less.

Instead, see the instructions for Form 1040, line 43.

1. Enter your taxable income from Form 1040, line 42 . . . **1.** 143,189
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 15 or line 16 of Schedule D . . . **7.** 137,253
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.** 137,253
10. Add lines 6 and 9 . . . **10.** 137,253
11. Add lines 18 and 19 of Schedule D . . . **11.** 13,253
12. Enter the **smaller** of line 9 or line 11 . . . **12.** 13,253
13. Subtract line 12 from line 10. . . . **13.** 124,000
14. Subtract line 13 from line 1. If zero or less, enter -0- . . . **14.** 19,189
15. Enter the **smaller** of:
- The amount on line 1 **or**
- $29,050 if single or married filing separately;
  $58,100 if married filing jointly or qualifying widow(er); or
  $38,900 if head of household

 . . . **15.** 29,050
16. Enter the **smaller** of line 14 or line 15 . . . **16.** 19,189
17. Subtract line 10 from line 1. If zero or less, enter -0- . . . **17.** 5,936
18. Enter the **larger** of line 16 or line 17 . . . ▶ **18.** 19,189
If lines 15 and 16 are the same, skip lines 19 and 20 and go to line 21. Otherwise, go to line 19.
19. Subtract line 16 from line 15 . . . ▶ **19.** 9,861
20. Multiply line 19 by 5% (.05) . . . **20.** 493
If lines 1 and 15 are the same, skip lines 21 through 33 and go to line 34. Otherwise, go to line 21.
21. Enter the **smaller** of line 1 or line 13 . . . **21.** 124,000
22. Enter the amount from line 19 (if line 19 is blank, enter -0-) . . . **22.** 9,861
23. Subtract line 22 from line 21. If zero or less, enter -0- . . . ▶ **23.** 114,139
24. Multiply line 23 by 15% (.15) . . . **24.** 17,121
If Schedule D, line 19, is zero or blank, skip lines 25 through 30 and go to line 31. Otherwise, go to line 25.
25. Enter the **smaller** of line 9 above or Schedule D, line 19 . . . **25.** 13,253
26. Add lines 10 and 18 . . . **26.** 156,442
27. Enter the amount from line 1 above . . . **27.** 143,189
28. Subtract line 27 from line 26. If zero or less, enter -0- . . . **28.** 13,253
29. Subtract line 28 from line 25. If zero or less, enter -0- . . . ▶ **29.** 0
30. Multiply line 29 by 25% (.25) . . . **30.** 0
If Schedule D, line 18, is zero or blank, skip lines 31 through 33 and go to line 34. Otherwise, go to line 31.
31. Add lines 18, 19, 23, and 29 . . . **31.** ______
32. Subtract line 31 from line 1 . . . **32.** ______
33. Multiply line 32 by 28% (.28) . . . **33.** ______
34. Figure the tax on the amount on **line 18**. Use the Tax Table or Tax Computation Worksheet, whichever applies . . . **34.** 2,519
35. Add lines 20, 24, 30, 33, and 34 . . . **35.** 20,133
36. Figure the tax on the amount on **line 1.** Use the Tax Table or Tax Computation Worksheet, whichever applies . . . **36.** 34,720
37. Tax on all taxable income (including capital gains and qualified dividends). Enter the **smaller** of line 35 or line 36. Also enter this amount on Form 1040, line 43 . . . **37.** 20,133

*If applicable, enter instead the smaller amount you entered on the dotted line next to line 4e of Form 4952.

Line # Above	Amount	Represents
9	$137,253	Total 2004 realized long-term gain on apartment building (from Form 6252, *Installment Sale Income*—form not shown)
11 & 12	13,253	Portion of the total $137,253 long-term gain attributable to §1250 unrecaptured gain

D-9

HIGHER STANDARD DEDUCTION FOR 2004

The next example shows one strategy that married taxpayers can use to take advantage of the marriage penalty relief provisions of JGTRRA of 2003.

Example 15. Prior to 2003, Fred and Ethyl's total allowable itemized deductions were typically slightly above the standard deduction amount for married taxpayers. Their charitable donations were their biggest variant. They were delighted by the Marriage Penalty Relief provisions of JGTRRA of 2003, and they astutely realized that they could save some tax dollars by:

- "Doubling up" on selected 2003 itemized deductions such as charitable donations and real estate taxes on their home, and
- Claiming the $9,700 standard deduction on their joint 2004 tax return.

As a result of their decision, they generated $13,000 of allowable 2003 itemized deductions. That figure was much greater than their allowable $9,500 standard deduction for 2003. **They "prepaid" most of their 2004 charitable donations and home property taxes in December 2003.** Therefore, their allowable 2004 itemized deductions are much lower than the $9,700 standard deduction that they will claim on their 2004 tax return.

Observations for Example 15

1. A systematic plan to itemize deductions every other year should be considered as a part of normal tax planning.
2. Even though the Marriage Penalty Relief provisions of JGTRRA were scheduled to terminate after 2004, there is considerable support in Congress to make these provisions permanent. These provisions, if enacted, would:
   - Keep the 15% tax bracket for married taxpayers twice as wide as for single taxpayers, and
   - Keep the standard deduction amount for married taxpayers double the amount allowed to single filers.

   If this proposed legislation is passed, it will make even more tax sense for married couples to consider "doubling up" on itemized deductions every other year for 2005 and later tax years.

Note. Some counties will not accept a December prepayment of the following year's real estate taxes. Check with your county treasurer to see if prepayments are permitted.

LOWER TAX RATES ON QUALIFIED DIVIDENDS

New Rules of JGTRRA of 2003 for Dividend Taxation

Prior to the changes provided in JGTRRA, dividends were taxed as ordinary income similar to interest income and wages. Consequently, prior to 2003, the tax rate on dividend income of individual taxpayers in the highest tax bracket was 38.6%.

Beginning in 2003, the taxation of qualified dividends was dramatically reduced. For taxable years 2003 through 2008, the maximum tax rate on "qualified dividend income" is 15% for taxpayers in the 25% or higher tax brackets.

The tax rate on dividend income for taxpayers who are in the 10% or 15% tax brackets is even lower. The dividend income of these lower-income taxpayers is taxed at 5% for taxable years 2003 through 2007. In 2008, the dividend tax rate for these taxpayers is reduced to zero.

However, the lower tax rates on "qualified dividend income" terminate after 2008**. In 2009, the rules for taxation of dividend income are scheduled to revert to the pre-2003 tax rules.** As a result, post-2008 dividend income will again be treated as ordinary income.

Conclusion. Clearly, high-income taxpayers with significant dividend income are "big winners" under JGTRRA. Those in the highest tax bracket benefit from a tax rate reduction on dividends from 38.6% to 15%, which is a striking 61% reduction in tax rates. In addition, many taxpayers with relatively high net worth but low taxable income benefit from the 5% tax rate on their dividend income.

Example 16. Marie and Joan are 75-year old widows in 2004. They have identical 2004 taxable incomes of $29,000. Neither has any 2004 investment interest expense. Detailed information concerning their respective 2004 adjusted gross income, taxable income, and total tax follows:

Marie's 2004 AGI, taxable income, and total tax information

Taxable pension income	$10,000
Interest income from bonds and CDs	28,150
Adjusted gross income	38,150
Less exemption	(3,100)
Less standard deduction	(6,050)
Taxable income	$29,000
Marie's total 2004 federal tax liability (from Tax Table)	$ 3,996

Joan's 2004 AGI, taxable income, and total tax information

Taxable pension income	$10,000
Qualified dividend income	28,150
Adjusted gross income	38,150
Less exemption	(3,100)
Less standard deduction	(6,050)
Taxable income	$29,000
Joan's total 2004 federal tax liability (dividends taxed at a 5% rate)	$ 1,493

Observations for Example 16

1. Even though Marie and Joan have identical taxable income, their effective tax rates are markedly different.
   - Marie's effective tax rate on her taxable income is 13.78% ($3,996 ÷ 29,000).
   - Joan's effective tax rate on her taxable income is only 5.15% ($1,493 ÷ 29,000).
2. Joan's 2004 taxable income of $29,000 is slightly below the $29,050 ceiling for the 15% tax bracket for single taxpayers. Therefore, all of her dividend income is taxed at the very favorable 5% rate.

Tax Planning Suggestions for Tax Years 2004–2008

1. Investors should ensure that their stock brokerage firm agrees not to borrow stock from the investor's account. The reason for this is that "payments in lieu of dividends" that an investor may receive from a broker on stock the broker temporarily lends to other customers are not considered dividends. Consequently, any "payments in lieu of dividends" received are not eligible for the lower 5% and 15% tax rates.

2. Stock paying a high dividend should probably be held in a taxable account rather than a tax-deferred retirement account like a traditional IRA. Any dividends received in a tax-deferred retirement account, with the exception of a Roth IRA, are eventually taxed as ordinary income when distributions are received.

3. Investors should consider preferred stock that pays qualified dividends but not interest. Preferred stock generally pays a higher rate of dividends than does common stock of the same company. Investors should check with a broker to verify that the preferred stock does pay qualified dividends.

4. Closely-held corporations should examine their compensation policy for owners. The familiar strategy of a high salary combined with no dividend payment may no longer apply. **However, remember that an unreasonable salary issue raised in an IRS exam can apply to unreasonably low salaries as well as unreasonably high salaries.** This is especially true in situations where related taxpayers are involved.

5. For 2004 individual calendar-year taxpayers, capital gain dividends received from mutual funds and real estate investment trusts (REITs) qualify for the lower 5% and 15% tax rates.

> **Note.** See the Capital Gains and Losses section of Chapter 13, Rulings and Cases, for an analysis of IRS Notice 2004-39.

RETIREMENT SAVINGS CONTRIBUTION 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. **This legislation provides a temporary nonrefundable credit for tax years 2002–2006.** For 2004, the maximum credit is $1,000 and is claimed on Form 8880, *Credit for Qualified Retirement Savings Contributions.*

The purpose of this provision is to give a tax incentive to low- and middle-income taxpayers to create or add to their retirement plans. The biggest obstacle in taking advantage of this credit is that many low- and middle-income taxpayers do not have sufficient cash flow to fund the various retirement plan contributions or deferrals.

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 a §401(k) plan, §403(b) tax-sheltered annuity, §457 plan for state or local government employees, salary reduction SEP plan, or SIMPLE IRA plan, 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 tax year,
- The taxpayer is **claimed as a dependent** on someone's (such as a parent) return, or
- The taxpayer is a **student,** as defined under IRC §151(c)(4).

Reductions to the Contributions Eligible for the Credit

If a taxpayer makes IRA contributions (traditional or Roth) or 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 the contributions to IRAs and elective deferrals eligible for the credit must be reduced (but not below zero).

The testing period consists of the:

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

Line 4 on Form 8880 is used to report these distributions. For more information, see the General Instructions for line 4 on page 2 of Form 8880 (not shown).

Example 17. Rich and Linda file a joint 2004 return. Linda contributed $3,000 to her traditional IRA for 2004. Rich received a $6,000 taxable distribution from his §401(k) plan in 2002. They also filed jointly in 2002.

Tax Solution for Example 17. Since Rich's withdrawal exceeds Linda's contribution, Linda is not eligible for the credit on the 2004 Form 8880. There is no need to include a 2004 Form 8880 with their joint 2004 Form 1040.

Example 18. Gary and Janet are married and file a joint 2004 return. They are not entitled to claim any other nonrefundable credits, such as education credits, on their 2004 return. Neither make IRA contributions or elective deferrals in 2004. They are not eligible to claim the saver's credit since they made no contributions.

Gary's 2004 wages	$23,000
Janet's 2004 wages	10,000
Interest income on money market account	2,000
2004 AGI	$35,000
Less: Exemptions (3 including one 18-year old dependent child)	(9,300)
Less: Standard deduction	(9,700)
2004 Taxable income	$16,000
Tax from Tax Table	**$ 1,689**

Example 19. Use the same facts as **Example 18** except, Gary makes a 2004 deductible contribution of $2,000 to his traditional IRA, and Janet makes a $2,000 elective deferral to her §401(k) plan in the same year. They are eligible to claim a saver's credit of $800.

2004 AGI ($35,000 minus $4,000)	$31,000
2004 Taxable income ($16,000 minus $4,000)	12,000
Tax from Tax Table	1,203
Less: Allowable saver's credit (see Form 8880)	(800)
2004 total tax after allowable saver's credit	**$ 403**

For Example 19

Form **8880**

Department of the Treasury
Internal Revenue Service

Credit for Qualified Retirement Savings Contributions

▶ Attach to Form 1040 or Form 1040A.
▶ See instructions on back.

OMB No. 1545-1805
2004
Attachment Sequence No. **129**

Name(s) shown on return: **Gary and Janet**

Your social security number

CAUTION

You **cannot** take this credit if **either** of the following applies.

- The amount on Form 1040, line 37, 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, 1987, **(b)** is claimed as a dependent on someone else's 2004 tax return, or **(c)** was a **student** (see instructions).

			(a) You		(b) Your spouse
1	Traditional and Roth IRA contributions for 2004. **Do not** include rollover contributions	1	2,000 00		
2	Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18)(D) plan contributions for 2004 (see instructions)	2			2,000 00
3	Add lines 1 and 2	3	2,000 00		2,000 00
4	Certain distributions received **after** 2001 and **before** the due date (including extensions) of your 2004 tax return (see instructions). If married filing jointly, include **both** spouses' amounts in **both** columns. See instructions for an exception	4	0 00		0 00
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	2,000 00		2,000 00
6	In each column, enter the **smaller** of line 5 or $2,000	6	2,000 00		2,000 00
7	Add the amounts on line 6. If zero, **stop**; you cannot take this credit			7	4,000 00
8	Enter the amount from Form 1040, line 37*, or Form 1040A, line 22	8	31,000 00		
9	Enter the applicable decimal amount shown below:			9	X . 2

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 take this credit.*

10	Multiply line 7 by line 9			10	800 00
11	Enter the amount from Form 1040, line 45, or Form 1040A, line 28	11	1,203 00		
12	Enter the total of your credits from Form 1040, lines 46 through 51, or Form 1040A, lines 29 through 32	12	0 00		
13	Subtract line 12 from line 11. If zero, **stop**; you cannot take this credit			13	1,203 00
14	**Credit for qualified retirement savings contributions.** Enter the **smaller** of line 10 or line 13 here and on Form 1040, line 52, or Form 1040A, line 33			14	800 00

*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** (2004)

Observations for Example 19

1. Even though theoretically both Gary and Janet are **each** entitled to a maximum $1,000 saver's credit in 2004, it is impossible for them to obtain their maximum $2,000 total saver's credit. This is due to two factors:
   - The low AGI thresholds that qualify for the 50% credit rate
   - The nonrefundable feature of the credit
2. If Gary's deductible IRA contribution was $3,000 rather than $2,000, their 2004 AGI would have been $30,000 rather than $31,000. In this case, their rate of credit on Form 8880, line 9 would be the maximum 50% rather than 20%.

   The result is a tentative credit of $2,000 on Form 8880, line 10 ($4,000 × 50%) rather than the $800 that their Form 8880 shows. However, they are only allowed to claim $1,000 of the $2,000 nonrefundable saver's credit, which is the amount of tax on $11,000 of taxable income.
3. Based on **Example 19** facts, Gary and Janet have $31,000 of 2004 earned income, as below.

Gary's W-2 wages	$23,000
Janet's W-2 wages of $8,000 (after her $2,000 §401(k) deferral)	8,000
Gary and Janet's 2004 earned income	$31,000

   Their earned income credit amount for one qualifying child is $50 from the EIC Table based on $31,000 of both AGI and earned income. Their investment income of $2,000 is below the $2,650 limitation amount of "disqualifying income" in 2004. Gary's $2,000 IRA contribution offsets the $2,000 of interest income in computing AGI.

   Gary and Janet are restricted to $800 of the refundable saver's credit. This has no effect on their refundable earned income credit. A **refundable** credit, such as EIC or the refundable portion of the child tax credit, is received by a taxpayer even if the total income tax figure is zero.

Note. For taxpayers like Gary and Janet who can claim both the EIC and the saver's credit, proper tax planning might increase the amount of EIC. There are situations where a deductible contribution to a traditional IRA could reduce the amount of EIC. In that case, a better tax decision would be to make a nondeductible contribution to a Roth IRA. For most taxpayers, maximizing EIC is more tax efficient than maximizing the nonrefundable saver's credit.

4. Gary and Janet had no other 2004 nonrefundable credits such as the Hope or Lifetime Learning or child care credits. However, if they did and if those credits exceeded their $1,200 total tax amount, they would not be entitled to any saver's credit for 2004.
5. Most low-income taxpayers like Gary and Janet would not have sufficient money market funds to generate $2,000 of interest income. However, in the more common situation where low-income taxpayers have little or no savings, affluent relatives such as parent(s) should consider gifting funds to them to take advantage of the tax savings offered by the saver's credit.
6. If the employer of the taxpayer has a matching program, making an elective deferral to a deferred compensation plan is usually a better option than making a contribution to either a traditional or a Roth IRA.

Example 20. Max and Ruth are each 60 years old. They both work for employers with a §401(k) plan and each earns $34,000 annually. Their goal is to save as much as possible for retirement. Therefore, they **each** make the maximum §401(k) deferral of $16,000 ($13,000 + $3,000 catch-up for those age 50 or over) for 2004. They also **each** make a $3,500 deductible 2004 contribution to their traditional IRAs.

Their 2004 joint return will report the following:

Wages (2 × ($34,000 gross wages – $16,000 maximum §401(k) deferral))	$36,000
Less deductible IRA contributions (2 × $3,500)	(7,000)
Adjusted gross income	$29,000
Less standard deduction	(9,700)
Less exemptions (2 × $3,100)	(6,200)
Taxable income	$13,100
Income tax (from Tax Table at a 10% rate)	$ 1,313
Less allowable nonrefundable saver's credit from Form 8880 ($4,000 × 50% = $2,000 but limited to tax amount of $1,313)	(1,313)
Total tax	$ 0

By maximizing their retirement savings options, they reduced their 2004 tax liability to zero**. If they had made no §401(k) deferrals and no IRA contributions, their total 2004 tax liability would be $7,100**. This theoretical example is unusual since Max and Ruth, who earn $68,000, probably could not afford to allocate $39,000 to their retirement goals.

PROBLEM 7: PASSIVE LOSS ISSUES

BACKGROUND INFORMATION

IRC §469, entitled Passive Activity Losses and Credits Limited, probably qualifies as the most complex and confusing code section to affect individual taxpayers. Consider these facts:

- IRC §469 encompasses five full pages in the IRC.
- The table of contents for the Treasury Regulations for §469 consists of 13 pages.
- The Treasury Regulations, issued in three main installments, are massive, detailed, and complex.
- The Instructions for Form 8582, *Passive Activity Loss Limitations,* consists of 12 pages.

Recent court cases involving claimed passive losses have generally involved the interpretation of the following specific areas of the code and/or regulations:

1. Whether the taxpayer qualified as a real estate professional under IRC §469(c)(7)(B)
2. Whether the self-rental rule of Treas. Reg. §1.469-2(f)(6) applies

Due to the increased enforcement effort of the IRS, this section emphasizes some of the areas of passive losses covered in the IRS MSSP entitled *Passive Activity Losses Reference Guide*. It is an official training manual for IRS examiners. Initially issued in 1994 and revised in 1996, it consists of 235 pages with seven chapters. It remains a valid reference source since there has been little change in the IRC or Treasury Regulations regarding passive losses since the 1996 revision.

> **Note.** The MSSP is available to the public on the IRS web site, www.irs.gov/pub/irs-mssp/pal.pdf.

The purpose of Problem 7 is to acquaint tax preparers with some of the passive loss issues that IRS examiners are trained to identify. Problem 7 is not intended to give the conclusion that the chapter author either agrees or disagrees with the IRS perspective.

OVERVIEW OF THE LAW AND FORM 8582

Passive Activity Defined

Income and losses on a tax return are divided into **two** categories:

- **Passive:** Rentals and businesses in which the taxpayer does not materially participate.
- **Nonpassive:** Businesses in which the taxpayer materially participates. Salaries, guaranteed payments, Form 1099 commission income, and portfolio or investment income are by definition nonpassive. (Portfolio income includes interest and dividend income, royalties, gains and losses on stocks, pensions, lottery winnings, and any other property held for investment.)

There are two types of **passive activities:**

1. **Rentals**, including both equipment and rental real estate, regardless of the level of participation. However, beginning in 1994, there is an exception for "real estate professionals."
2. **Businesses in which the taxpayer does not materially participate** on a regular, continuous, and substantial basis. The tests for material participation are found in Temp. Treas. Reg. §1.469-5T.

> **Note.** Since limited partners **generally** cannot meet the material participation standard, their share of partnership income or loss **usually** is entered on Form 8582, line 3, in the "All Other Passive Activities" area. The income or loss of a limited partner **should not usually** be entered on Form 8582, line 1, in the "Rental Real Estate With Active Participation" area.
>
> See page 4 of the Form 8582 Instructions for the three ways a limited partner can meet the material participation test for trade or business activities.

Form 8582

Income and losses from passive activities are most commonly found on Schedule E, *Supplemental Income and Loss*. This is where the taxpayer reports rental activities and pass-through amounts from partnerships, S corporations, and trusts. The computational form used to limit losses from passive activities is Form 8582.

If the taxpayer materially participates in the activity, the income and losses are not entered on Form 8582. Real estate activities of qualifying "real estate professionals" are not considered passive activities and therefore should be omitted from Form 8582.

Taxpayers with multiple passive activities should complete 7 worksheets in order to prepare Form 8582. The first three worksheets combine the activities for lines 1, 2, and 3 of the form. The remaining worksheets allocate allowed and disallowed losses among the activities and show where the allowable losses are deducted (Schedules E, C, F, etc.).

Part I of Form 8582 simply divides the passive activities into three types. Rental real estate activities with active participation are shown on line 1. Commercial revitalization deductions are shown on line 2. All other passive activities, including any equipment rentals and limited partnerships, are entered on line 3.

Parts II and III are used to calculate the allowable losses/deductions from lines 1 and 2 based on the available $25,000 special allowance.

Part IV simply calculates the total allowable passive activity losses for the year. Line 16 is the last line of Part IV, and it shows the amount of losses to allocate among the activities. It equals the passive activity income (from lines 1a and 3a) plus the losses allowed (from Parts II and III).

If Form 8582, line 16 is less than the sum of lines 23 and 28(f), Schedule E, the taxpayer is probably deducting more than an allowable passive loss. However, there is a major exception for "real estate professionals."

Form **8582**

Department of the Treasury
Internal Revenue Service

Passive Activity Loss Limitations

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

OMB No. 1545-1008

2004

Attachment Sequence No. 88

Name(s) shown on return | **Identifying number**

Part I **2004 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)) **Never portfolio or self-rented activities** . . . **1a**

b Activities with net loss (enter the amount from Worksheet 1, column (b)) . . . **1b** ( )

c Prior years unallowed losses (enter the amount from Worksheet 1, column (c)) . . . **1c** ( )

d Combine lines 1a, 1b, and 1c . . . **1d**

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 **Limited partners, equipment rentals, etc.**

3a Activities with net income (enter the amount from Worksheet 3, column (a)) . **Never nonpassive income** . . **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**

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**

6 Enter $150,000. If married filing separately, see page 8 . . . **6**

7 Enter modified adjusted gross income, but not less than zero (see page 8) **7**

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 8 **9**

10 Enter the **smaller** of line 5 or line 9 . **Losses from 1d allowed** **10**

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 **All passive income** . . . **15**

16 **Total losses allowed from all passive activities for 2004.** 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**

For Paperwork Reduction Act Notice, see page 12 of the instructions. Cat. No. 63704F Form **8582** (2004)

Line 16 = Passive income plus allowable rental real estate loss

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

2004

Attachment Sequence No. 13

Name(s) shown on return | **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-2). Report farm rental income or loss from **Form 4835** on page 2, line 40.

1	List the type 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			A		
B			B		
C			C		

		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
Income:						
3 Rents received	3				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					
12 Mortgage interest paid to banks, etc. (see page E-4)	12				12	
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16					
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19				19	
20 Depreciation expense or depletion (see page E-4)	20				20	
21 Total expenses. Add lines 19 and 20	21					
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-4 to find out if you must file **Form 6198**	22					
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-4 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	
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) 2004**

Schedule E (Form 1040) 2004 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side. | Your social security number

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check column **(e)** on line 28 and attach **Form 6198.** See page E-1.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? ☐ **Yes** ☐ **No**
If you answered "Yes," see page E-5 before completing this section.

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A					
B					
C					
D					

	Passive Income and Loss		Nonpassive Income and Loss		
	(f) Passive loss allowed (attach Form 8582 if required)	(g) Passive income from Schedule K–1	(h) Nonpassive loss from Schedule K–1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K–1
A					
B					
C					
D					
29a Totals					
b Totals					

30	Add columns (g) and (j) of line 29a	30	
31	Add columns (f), (h), and (i) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32	

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K–1	(e) Deduction or loss from Schedule K–1	(f) Other income from Schedule K–1
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36. Enter the result here and include in the total on line 41 below	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see page E-6)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Part V Summary

40	Net farm rental income or (loss) from **Form 4835**. Also, complete line 42 below	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17 ▶	41	
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code N; and Schedule K-1 (Form 1041), line 14 (see page E-6)	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see page E-1), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

Printed on recycled paper **Schedule E (Form 1040) 2004**

REAL ESTATE PROFESSIONALS

Beginning in 1994, a taxpayer who meets all of the following tests can deduct current-year rental real estate losses in full, regardless of any AGI limitations.

1. More than half of the taxpayer's personal services performed in all trades or businesses during the tax year are performed in real property trades or businesses.[17]

> **Note.** Real property trades or businesses include real estate: (a) development, (b) construction, (c) acquisition, (d) conversion, (e) rental, (f) operation, (g) management, (h) leasing, or (i) brokerage.[18]

2. More than 750 hours of services are performed during the tax year in real property trades or businesses in which the taxpayer materially participates.[19]

3. The taxpayer must materially participate in **each** rental real estate activity **unless** an election to group **all** rental real estate activities as a single activity (for purposes of meeting the material participation test) was filed.[20]

For the first two tests, each spouse's time is taken into account separately. Therefore, at least one spouse must satisfy the personal service and 750 hour requirements. For the third test, both spouses' time can be combined, but only time applied to rental real estate activities (and not to real property trades or businesses) is counted.

> **Note.** Further information on this topic can be found in the "Real Estate Professionals" section of Chapter 11, Special Taxpayers, and Chapter 13, Rulings and Cases. See an analysis of the *Galagar*[21] Tax Court case in the Passive Activities section of Chapter 13, Rulings and Cases.
>
> See also pages 624–626 in the *2003 University of Illinois Federal Tax Workbook*. The *Jahina*[22] Tax Court case, which involves the failure of Mrs. Jahina to make the required election shown in test 3, is thoroughly analyzed.
>
> See also pages 344–346 in the *2002 University of Illinois Farm Income Tax Workbook*. The *Bailey*[23] Tax Court case, which addresses the detailed records required for tests 1 and 2, is analyzed.

SPECIFIC EXAMINATION ISSUES

The IRS might consider some of the following when auditing returns with claimed passive losses:

- **Real estate professionals.** Do taxpayers claiming more than $25,000 in rental real estate losses meet all the required tests to qualify as a "real estate professional?"
- **Self-rental.** Is the taxpayer incorrectly attempting to use rental profit from a business in which he materially participated to generate allowance of passive losses? Temp. Treas. Reg. §1.469-2T(f)(6) recharacterizes rental profits from self-rented property as nonpassive income.
- **Equipment rentals.** Equipment rentals of any kind do not qualify for the $25,000 special allowance loss in Part II of Form 8582. This passive activity should be reported on line 3 in the "All Other Passive Activities" area and never on line 1 in the "Rental Real Estate Activities With Active Participation" area.

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17. IRC §469(c)(7)(B)(i)
18. IRC §469 (c)(7)(C)
19. IRC §469(c)(7)(B)(ii)
20. IRC §469(c)(7)(A)
21. *Alfredo A. and Jane R. Galagar v. Commr.,* TC Summary Opinion 2004-39, March 25, 2004
22. *Karl and Birgit Jahina v. Commr.,* TC Summary Opinion 2002-150, November 21, 2002
23. *Bruce and Judy Bailey v. Commr.,* TC Memo 2001-296, November 7, 2001

If the equipment rental activity does not fall into one of the six exceptions shown in Temp. Treas. Reg.§1.469-1T(e)(3)(ii), losses are not allowable unless the taxpayer has offsetting passive income.

In brief, the six exceptions are:

1. Average period of customer use is seven days or less. **Examples:** video stores that rent movies and games; automobile rental businesses; formal wear businesses; tool rental businesses; hotels and motels.
2. Significant personal services are provided and the average period of customer use is 30 days or less. **Example:** hotels with maid service.
3. Extraordinary personal services are provided for the customer. **Examples:** hospitals and boarding schools.
4. The rental is incidental to a nonrental activity.

Note. A detailed analysis of the third and fourth exceptions can be found on pages 623–24 in the *2003 University of Illinois Federal Tax Workbook*. The *Kessler*[24] Tax Court case, which involves the "extraordinary personal service" and the "incidental rental" exceptions, is analyzed.

5. Nonexclusive use by various customers of the property. **Examples:** golf courses and health spas.
6. Rental to an entity owned by the taxpayer. **Examples:** partnership, S corporation, or joint venture.

Caution. If one of the six exceptions applies, the taxpayer must still meet the material participation test to deduct any equipment rental net loss.

Example 21. The tax return contains a Schedule C for an "equipment lease" business. A $37,000 loss is deducted in full, no Form 8582 is attached to the return, and there is no passive income. The examination reveals that the taxpayer is renting personally-owned equipment on a long-term basis (over seven days) to an unrelated partnership.

Tax Solution for Example 21. Without passive income, the $37,000 Schedule C loss is not allowed due to the passive loss limitations.[25] The $37,000 loss is a suspended passive loss which is carried to the next taxable year.

Note. Common examples of long-term (over seven days) equipment leases normally reported on Schedule C are:

- Computer leases
- Truck or heavy equipment rentals
- Airplane leases
- Office machinery leases
- Automobile rentals
- Boats or other personal property leased to another entity

24. *Paul and Pauline Kessler v. Commr.*, TC Memo 2003-185, 85 TCM 1543, June 26, 2003

25. IRC §469(a)(2)

Taxpayer's Arguments to Tax Solution. The usual argument is that the material participation or active participation standard has been met. Neither one applies since losses from equipment rentals are passive by definition. Losses on equipment rentals without offsetting passive income simply are not deductible unless one of the six exceptions shown previously applies.

Example 22. The tax return contains a Schedule E for two rental activities:

- A rental real estate property in which the taxpayer actively participates with a loss of $12,000
- Equipment rented on a long-term (over seven days) basis to an unrelated S corporation with a loss of $10,000

Both losses are reported on line 1 of Form 8582 in the "Rental Real Estate With Active Participation" area and are deducted in full on Schedule E. There is no passive income.

Tax Solution for Example 22. The rental real estate loss of $12,000 is deductible assuming the taxpayer qualifies for the $25,000 "special allowance" in Part II of Form 8582. However, the $10,000 loss on the equipment rental is not deductible. It should have been reported on line 3b on Form 8582 in the "All Other Passive Activities" area. The $10,000 disallowed loss is a suspended loss.

MILITARY DIFFERENTIAL PAY

In response to numerous questions regarding military differential pay, the IRS posted the following questions and answers on its web site at: www.irs.gov/newsroom/article/0,,id=129833,00.html

Q-38. What is military differential pay?

A-38. Differential pay is defined as payments made voluntarily by an employer to represent the difference between the regular salary of an employee called to military active duty and the amount being paid by the military, if the regular salary was higher. For purposes of the following questions and answers, the term differential pay also includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty.

Q-39. If an employer pays military differential pay to an employee called to active duty, are these payments considered wages?

A-39. The employment relationship between the employee and the company was terminated when the worker was called for active military service with the U.S. government or for active service with the state National Guard. Under the circumstances, the payments made by the company to the former employees while they are in military service with the U.S. government or active service with the state National Guard are not "wages" for services performed in "employment" for the companies. These payments, therefore, are not "wages" subject to the taxes imposed by the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) or to the Collection of Income Tax at Source on Wages.

Reference: IRS Revenue Ruling 69-136

Q-40. What is the tax treatment of military differential pay?

A-40. Certain compensation received for active service in a combat zone by members of the Armed Forces of the United States is excludable from gross income. However, this exclusion applies only to compensation paid by the Armed Forces of the United States to members of the Armed Forces. Compensation paid by other employers (whether private enterprises or governmental entities) to members of the Armed Forces cannot be excluded as combat zone compensation even if the recipient is performing active military service in a combat zone at the time the payment is made.

Q-41. If an employee is called to active duty and receives military differential pay, how are these payments reported by the employer to the employee?

A-41. Employers report military differential pay on Form 1099-MISC, Box 3: Other Income. Form W-2 is **not used** for these payments. Employers should not withhold FICA or income tax from these payments and the payments are not subject to FUTA taxes.

Q-42. How does a person who receives military differential pay report this on the federal income tax return?

A-42. The recipient reports the Form 1099-MISC amount on Line 21 of Form 1040 (Other Income) and lists the type as Military Differential Pay. No self-employment tax is due because the income from these payments is not derived from any trade or business conducted by the taxpayer for self-employment tax purposes.

Q-43. Since these payments are considered income but not "wages" subject to withholding, what should persons receiving these payments do to avoid owing large amounts of tax when they file their returns?

A-43. Since the employer is not required to withhold income tax, the recipient should prepare for the tax liability by making quarterly estimated tax payments.

One option is for the taxpayer to sign up for the Electronic Federal Tax Payment System (EFTPS), which enables the person to schedule payments directly from a bank account for up to a year in advance. This is a preferred method, since it is easiest for both the taxpayer and the government and ensures prompt and accurate crediting of payments to the taxpayer's account. Other options are to make credit card payments or send checks with Form 1040-ES vouchers.

SOCIAL SECURITY TAXES (FICA)

Q-44. Are there any benefit reductions due to FICA not being withheld by the employer?

A-44. Military personnel have FICA taken out of their military pay even when serving in a combat zone. Thus, they will get social security credit for their military earnings. However, social security retirement benefits are based on a worker's total earnings history. Since the military differential pay is not subject to FICA, the person's social security retirement benefits may be reduced.

Q-45. How does an employer correct the Form 941 (Quarterly Employment Tax Return) if FICA and income taxes have been erroneously withheld?

A-45. Generally, taxpayers can correct errors on Forms 941 for prior quarters by making an adjustment on Form 941 for the quarter during which the error is discovered. The adjustment increases or decreases the taxpayer's tax liability for the quarter in which it is reported and is interest-free. The taxpayer must provide background information and certifications supporting prior quarter adjustments. This information is reported by filing a Form 941C, *Supporting Statement to Correct Information*, with the current quarter. Form 941C is not filed separately. The IRS will not be able to process adjustments on Form 941 without this supporting information.

If excess FICA was paid in a prior period, the taxpayer can also recover the excess amount by filing a refund claim using Form 843. Form 941C, or an equivalent statement, must be filed with Form 843.

Q-46. How does an employee recover FICA taxes that were erroneously withheld by the employer?

A-46. Employees are encouraged to contact their employers and request that they seek a refund of the erroneously withheld FICA on the employees' behalf. Because employers also pay a portion of FICA that is not withheld from payments to the employee, the employer will also be entitled to a refund. The employer may have other similarly situated employees who are entitled to refunds and the IRS can process a single refund claim filed by the employer more efficiently than it can process numerous refund claims filed by individual employees. If the employer refuses to seek a refund on the employee's behalf, the employee may file a refund claim using Form 843. Line 5 is where the employee explains the reason for the refund and efforts made to secure it. The employee's claim for refund must include a statement from the employer indicating whether the employer has reimbursed any of the erroneously withheld FICA to the employee or filed a refund claim for any of the erroneously withheld FICA.

OTHER BENEFITS

Q-47. What is the tax treatment of health care benefits and coverage while the employee is on active military duty?

A-47. Generally, the gross income of an employee does not include employer-provided coverage under an accident or health plan or employer contributions to such plans. This exclusion from gross income extends to employees who are on military leave. The value of employer-provided coverage, or employer contributions to accident or health plans, is not reported on the Form 1099-MISC given to the employee.

Q-48. Is the cost of group term life insurance included in gross income while the employee is on military pay?

A-48. The tax treatment of group term life insurance coverage provided to employees on military leave is the same as coverage provided to current employees. Generally, the cost of $50,000 of group term life insurance coverage is not included in gross income while the employee is on military leave.

Q-49. If an employer pays an employee who is called to active duty his vacation pay is this pay subject to social security, Medicare and income taxes?

A-49. Yes, vacation pay that is earned or accrued prior to the worker being called for active duty or active service is subject to withholding as if it were a regular wage payment, even if paid to the worker after activation. When vacation pay is in addition to regular wages for the vacation period, it is treated as a supplemental wage payment. If the vacation pay is for a time longer than the usual payroll period, it is spread over the pay periods for which the taxpayer paid it. Vacation pay that is earned or accrues after the employment relationship is terminated by activation is not a wage payment.

Q-50. If a co-worker wants to donate vacation time to an employee who is called to active duty to whom is such leave taxable?

A-50. The donated vacation time is taxable to the recipient of the vacation time. As a result, the employee on active duty receiving donated vacation pay is subject to withholding of social security, Medicare and income taxes as if it were a regular wage payment. When vacation pay is in addition to regular wages for the vacation period, it is treated as a supplemental wage payment. If the vacation pay is for a time longer than the usual payroll period, it is spread over the pay periods for which the taxpayer paid it.

Q-51. An employee received an award from the employer and wishes to donate it to a co-worker who has been called to active duty. To whom is the award taxable?

A-51. The award is taxable to the recipient. The recipient's award is subject to withholding of social security, Medicare and income taxes as if it were a regular wage payment. When an award is in addition to regular wages, it is treated as a supplemental wage payment.