Chapter 11: Special Taxpayers

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

TAXATION OF ALIENS

INTRODUCTION

The U.S. Internal Revenue Code defines aliens as individuals who are residents of countries outside the United States and who travel to the United States for various personal, business, political, and diplomatic reasons. If aliens earn income while in the United States, they may be subject to U.S. federal income taxes. The following section discusses the various complexities of these situations.

ENTRY TO THE UNITED STATES

Foreigners need a visa in order to travel to the United States. This visa only permits the holder to travel to a U.S. port of entry. Foreign citizens and residents must apply for their visas at American embassies or consulates abroad before they travel to the United States. The type of visas that aliens receive vary according to the purpose of their travel. Aliens entering the United States for **permanent residence** are given an **immigrant visa** by a U.S. consulate at the place of departure. The Department of Homeland Security replaces the immigrant visa with an alien registration card, or "green card," upon arrival.

For income tax purposes, **an alien who possesses a green card is considered to be a resident alien and is taxed in the same manner as a U.S. citizen.** The **nonresident alien** is granted a **nonimmigrant visa** and this individual is also subject to **a special set of federal income tax rules.**

Listings of both immigrant (resident) and nonimmigrant (nonresident) visas are illustrated at the U.S. Citizenship and Immigration Services website: www.uscis.gov/graphics/services/visas.htm.

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Nonimmigrant (Nonresident Alien) Visas

Visa	Classifications
A-1	Ambassador; public minister; career, diplomatic, or consular officer
B-1	Temporary visitor for business
C-1	Alien in transit
F	Academic student
G	Principal resident representative of recognized foreign government to foreign government to international organization, and members of immediate family
H-1B	Specialty occupations, DOD workers, fashion models
H-1C	Nurses going to work for up to three years in health profession shortage areas
H-2A	Temporary agricultural worker
H-2B	Temporary worker (skilled and unskilled)
H-3	Trainee
J	Exchange visitor
L-1A	Executive, managerial
M-1	Vocational student or other nonacademic student
O-1	Extraordinary ability in sciences, arts, education, business or athletics
P-1	Individual or team athletes
R-1	Religious workers

ALIEN CLASSIFICATION

Aliens fall into one of two basic categories: resident aliens and nonresident aliens.

Resident Alien

An individual is treated as a resident alien of the United States for any calendar year if he:[1]

1. Is a lawful permanent resident of the United States during any part of that calendar year,
2. Has met the substantial presence test, or
3. If otherwise eligible, he elects to be treated as a resident alien for federal income tax purposes.[2]

Resident aliens are also referred to as immigrant aliens. Resident aliens, although not U.S. citizens, can be granted such status upon entry into the United States. **The resident alien files Form 1040, 1040A, or 1040EZ.** For tax purposes, they are treated as U.S. citizens.

Nonresident Alien

A nonresident alien can be reclassified as a resident alien by meeting any one of the three requirements. A nonresident alien is any individual who is neither a citizen of the United States nor a resident of the United States.[3] Nonresident aliens are also referred to as nonimmigrant aliens. Nonresident aliens enter the United States for a specific reason, such as attending college. Consequently, their periods of presence are limited. The nonresident alien files Form 1040NR, or 1040NR-EZ.

1. IRC §7701(b)(1)(A)
2. IRC §7701(b)(4)
3. IRC §7701(b)(1)(B)

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SUBSTANTIAL PRESENCE TEST

An alien who does not have a green card is considered a U.S. resident alien for federal income tax purposes if he meets the substantial presence test.[4] This is a two-part test and both parts must be met.

Test 1: At least 31-day presence test. The individual was present in the United States on at least 31 days during the current calendar year.

Test 2: At least 183-day test. The total days for the substantial presence test are equal to or greater than 183 days. This is determined by calculating the sum of the days the alien was present in the United States during the current year and the two preceding calendar years. If this sum, when multiplied by the applicable factor, equals or exceeds 183 days, the test is met.

Applicable Factors. To determine whether the 183-day requirement is met, the following are considered days of presence:

- All days present in the current year
- One third of the days present in the first year preceding the current year
- One sixth of the days present in the second year preceding the current year

Example 1. Marco is a nonresident alien. He is present in the United States for 120 days in each of years 2001, 2002, and 2003. The following calculation is made to determine if Marco meets the substantial presence test.

Total Days for the Substantial Presence Test

Year	Days Present	Multiplier	Total Adjusted Days
2003	120	1	120
2002	120	1/3	40
2001	120	1/6	20
			180

Since the result is less than the 183-day requirement, Marco is classified as a nonresident alien. If he is required to file, he must use Form 1040NR, or 1040NR-EZ.

Example 2. Use the same facts as **Example 1** except, Marco arrived in the U.S. in 2003 and has an H-1 visa. He remained in the U.S. for 195 days in 2003.

Since Marco satisfied both of the substantial presence tests (31-day and 183-day requirement), he is classified as a resident alien for federal income tax purposes. If he is required to file an income tax return, he must use Form 1040, 1040A, or 1040-EZ.

4. IRC §7701(b)(3)

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Exceptions to the Substantial Presence Test

There are five exceptions to the substantial presence test. Aliens who meet the criteria of these exceptions are treated as nonresident aliens. Family members whose visas are contingent on the status of another alien receive the same treatment as the primary visa holder. The five exceptions are as follows:

1. **Exempt Individuals.** Exempt individuals are entitled to exclude their days of presence toward the substantial presence test.[5] In general, a nonresident alien is exempt for any day on which he is a:

    - **Foreign government-related individual**, including a diplomat or family member of a diplomat;
    - **Teacher or trainee** who is temporarily present in the United States under a J or Q visa and is not a student;
    - **Student** who is temporarily present in the United States under subparagraph F, J, Q or M visa; or
    - **Professional athlete** who is temporarily in the United States to compete in a charitable sports event.

    There are special rules for teachers, trainees, and students. The number of years during which a teacher, trainee, or student can be an exempt individual is limited.[6]

2. **Commuters from Canada or Mexico.** If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico, the individual is not considered being present in the United States on any day during which he commutes.[7]

3. **Aliens in Transit.** If an individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours, the individual is not considered present in the United States on any day during his transit.[8]

4. **Medical Exception.** Occasionally, an alien may not be able to depart the United States as planned, due to a medical condition that arose while the individual was in the United States. The days that she was not able to leave are not counted for substantial presence test purposes.[9]

5. **Closer Connection to a Foreign Country.** Days of presence in the United States do not count toward the substantial presence test if an individual is present fewer than 183 days during the current year and a closer connection to a foreign country is established.[10]

INCOME TAX TREATIES

A tax treaty is an agreement between the United States and a foreign country which provides income tax benefits to a nonresident alien individual. These individuals are residents of a foreign country and are visiting the United States for a limited time period and for a specific purpose. The most common classes of aliens subject to U.S. tax or exemption from U.S. tax include students (undergraduate and graduate), researchers, professors, and temporary workers. An alien's visa type depends on the reason the individual is in the United States.

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5. IRC §7701(b)(5)
6. IRC §7701(b)(5)(E)
7. IRC §7701(b)(7)(B)
8. IRC §7701(b)(7)(C)
9. IRC §7701(b)(3)(D)(ii)
10. IRC §7701(b)(3)(B)

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An income tax treaty usually serves dual purposes.

1. A treaty attempts to eliminate taxation of the same income items by multiple countries.
2. The provisions of a treaty also target the prevention of income tax evasion.

The U.S. presently has agreements or treaties with many foreign countries. The actual language of the treaties and their technical explanations can be viewed at the IRS website. The IRS Pub. 901, *U.S. Tax Treaties*, also contains details on U.S. income tax agreements with other countries.

IDENTIFICATION NUMBERS

In most cases, aliens are required to have a tax identification number. A tax identification number must be provided on returns, statements, and other tax-related documents.

Generally, the tax identification number is a social security number (SSN). The alien must complete Form SS-5, *Application for a Social Security Number,* and appear in person at a local Social Security Office to finalize the application process. The Social Security Administration (SSA) requires several documents, including the alien's visa, related cards or documentation issued by Immigration, and any other documentation that supports an individual's need for an SSN. For example, many states do not issue a driver's license to an individual who does not have a valid SSN.

If an alien does not have and is not eligible to obtain an SSN, she must apply for an individual taxpayer identification number (ITIN.) Dependent aliens and alien spouses who are claimed as exemptions are examples of individuals who should apply for an ITIN. In general, neither the spouse nor dependants of an alien are eligible for an SSN, but may be required to have an ITIN. Individuals apply for an ITIN by completing Form W-7, *Application for IRS Individual Taxpayer Identification Number*. Unlike the SSN, the ITIN is used for federal income tax purposes only. It does not entitle the alien to any social security benefits. An alien must have an ITIN if she is required to file any U.S. tax returns or documents.

Aliens who are engaged in a trade or business as a sole proprietor and who have employees or a qualified retirement plan, need an employer identification number (EIN). The EIN is necessary for filing most business-related returns and documents.

INCOME CLASSIFICATION AND RETURNS

Resident Alien Income

Resident alien income is treated the same as income of a permanent U.S. resident.

Nonresident Alien's Income

When preparing an income tax return for a nonresident alien, the alien's income must first be divided into the following categories:

Income Effectively Connected with a U.S. Trade or Business. This type of income is taxed at the same rates applied to U.S. citizens and residents. Income is reported on page 1 of Form 1040NR or 1040NR-EZ. Income from self-employment in the United States and wages paid by a U.S. employer are typical examples of the type of income that a tax professional will encounter.

U.S. Income Not Effectively Connected with a U.S. Trade or Business. This type of income is usually taxed at a flat rate of 30%. This income may be taxed at a lower rate if a treaty exists between the United States and the alien's country of residence specifies a lower rate. This category of income is reported on Form 1040NR, page 4. Form 1040NR-EZ cannot be used if any of the alien's income falls into this category. This class of income includes pension and annuities, capital gains, dividends paid by U.S. and foreign corporations, and royalties.

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Income Exempt from U.S. Tax. This type of income requires special efforts on the parts of the alien and the payor withholding agent (see the section that follows, "Deductible Amounts: Federal Per Diem Rate," et seq.). In brief, in order to claim treaty benefits, an alien may be required to complete items L and/or M on Form 1040NR, page 5, and Form 1040NR, page 1, line 22.

Example 3. Maria is a healthcare professional and a resident of the Philippines. She is temporarily present in the United States as a participant in a U.S. government-sponsored program. The program's primary purpose is research.

Maria arrived in the U.S. on January 1, 2004, and will return to the Philippines on or before December 31, 2004. She earned $15,000 in 2004 for conducting research. She did not complete Form 8233 upon arriving in the U.S. to claim treaty benefits. She received a 2004 Form W-2 reflecting her wages of $15,000 and federal income tax was withheld. Her only other 2004 U.S. income was interest of $87.00 earned on her checking and savings accounts.

A treaty exists between the United States and the Philippines. A Philippine resident, who is temporarily present in the U.S. for one year or less conducting U.S.-sponsored research is exempt from U.S. tax for income earned while conducting research. The maximum treaty benefit is $10,000.

As a general rule, interest income received by a nonresident alien **is excluded** from taxation if the interest is earned on monies placed on deposit with a bank, savings and loan, credit union or insurance company.[11]

Maria's 2004 Form 1040NR reporting of taxable income, treaty benefit, and excludable interest income follows.

[11] IRC §871(i)

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2004 Workbook

For Example 3

Form **1040NR** Department of the Treasury Internal Revenue Service

U.S. Nonresident Alien Income Tax Return

For the year January 1–December 31, 2004, or other tax year beginning , 2004, and ending , 20

OMB No. 1545-0089 **2004**

Please print or type.

Your first name and initial	Last name	Identifying number (see page 7 of inst.)
Maria		123-45-6789
Present home address (number, street, and apt. no., or rural route). If you have a P.O. box, see page 7.		Check if: ☑ Individual ☐ Estate or Trust
City, town or post office, state, and ZIP code. If you have a foreign address, see page 7.		**For Disclosure and Paperwork Reduction Act Notice, see page 27.**
Country ▶	Of what country were you a **citizen** or national during the tax year? ▶	
Give address **outside the United States** to which you want any refund check mailed. If same as above, write "Same."	Give address in the country where you are a **permanent resident.** If same as above, write "Same."	

Draft as of 07/16/2004

Attach Forms W-2 here. Also attach Form(s) 1099-R if tax was withheld.

Filing Status and Exemptions for Individuals (see page 7)

Filing status. Check only one box (1–6 below).

		7a Yourself	7b Spouse
1	☐ Single resident of Canada or Mexico, or a single U.S. national		
2	☑ Other single nonresident alien	✓	
3	☐ Married resident of Canada or Mexico, or a married U.S. national } If you check box 7b, enter your spouse's identifying number ▶		
4	☐ Married resident of Japan or the Republic of Korea		
5	☐ Other married nonresident alien		
6	☐ Qualifying widow(er) with dependent child (see page 7)		

Caution: ***Do not*** *check box 7a if your parent (or someone else) can claim you as a dependent.* ***Do not*** *check box 7b if your spouse had any U.S. gross income.*

No. of boxes checked on 7a and 7b ▶ 1

7c Dependents: (see page 8)

(1) First name Last name	(2) Dependent's identifying number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 8)
			☐
			☐
			☐
			☐

No. of children on 7c who:
- **lived with you** ▶
- **did not live with you due to divorce or separation** ▶
- **Dependents on 7c not entered above** ▶

d Total number of exemptions claimed . . . **Add numbers entered on lines above** ▶ **1**

Enclose, but do not attach, any payment.

Income Effectively Connected With U.S. Trade/Business

Line	Description		Amount
8	Wages, salaries, tips, etc. Attach Form(s) W-2	8	5,000 00
9a	**Taxable** interest	9a	
b	**Tax-exempt** interest. **Do not** include on line 9a — 9b		
10a	Ordinary dividends	10a	
b	Qualified dividends (see page 10) — 10b		
11	Taxable refunds, credits, or offsets of state and local income taxes (see page 10)	11	
12	Scholarship and fellowship grants. Attach Form(s) 1042-S or required statement (see page 10)	12	
13	Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	13	
14	Capital gain or (loss). Attach Schedule D (Form 1040) if required. If not required, check here ☐	14	
15	Other gains or (losses). Attach Form 4797	15	
16a	Total IRA distributions 16a — **16b** Taxable amount (see page 11)	16b	
17a	Pensions and annuities 17a — **17b** Taxable amount (see page 11)	17b	
18	Rental real estate, royalties, partnerships, trusts, etc. Attach Schedule E (Form 1040)	18	
19	Farm income or (loss). Attach Schedule F (Form 1040)	19	
20	Unemployment compensation	20	
21	Other income. List type and amount (see page 13)	21	
22	Total income exempt by a treaty from page 5, Item M — 22: 10,000 00		
23	Add lines 8, 9a, 10a, 11–15, 16b, and 17b–21. This is your **total effectively connected income** ▶	23	5,000 00

Adjusted Gross Income

Line	Description		Amount
24	Deduction for clean-fuel vehicles (see page 13)	24	
25	IRA deduction (see page 14)	25	
26	Student loan interest deduction (see page 14)	26	
27	Health savings account deduction. Attach Form 8889	27	
28	Moving expenses. Attach Form 3903	28	
29	Self-employed health insurance deduction (see page 14)	29	
30	Self-employed SEP, SIMPLE, and qualified plans	30	
31	Penalty on early withdrawal of savings	31	
32	Scholarship and fellowship grants excluded	32	
33	Add lines 24 through 32	33	
34	Subtract line 33 from line 23. Enter here and on line 35. This is your **adjusted gross income** ▶	34	5,000 00

Cat. No. 11364D Form **1040NR** (2004)

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For Example 3

Form 1040NR (2004) Page **5**

Other Information (If an item does not apply to you, enter "N/A.")

A What country issued your passport? **Philippines**

B Were you ever a U.S. citizen? ☐ Yes ☑ No

C Give the purpose of your visit to the United States ▶ **Health research nurse**

D Type of entry visa ▶ **H-1A** and current nonimmigrant status and date of change (see page 25) ▶ **N/A**

E Date you entered the United States (see page 25) ▶ **January 1, 2004**

F Did you give up your permanent residence as an immigrant in the United States this year? ☐ Yes ☑ No

G Dates you entered and left the United States during the year. Residents of Canada or Mexico entering and leaving the United States at frequent intervals, give name of country only. ▶ **Entered USA on January 1, 2004**

H Give number of days (including vacation and nonworkdays) you were present in the United States during:
2002 **0**, 2003 **0**, and 2004 **153**.

I If you are a resident of Canada, Mexico, Japan, or the Republic of Korea (South Korea), or a U.S. national, did your spouse contribute to the support of any child claimed on Form 1040NR, line 7c? ☐ Yes ☐ No
If "Yes," enter amount ▶ $ **N/A**

If you were a resident of Japan or the Republic of Korea (South Korea) for any part of the tax year, enter in the space below your total foreign source income not effectively connected with a U.S. trade or business. This information is needed so that the exemption for your spouse and dependents residing in the United States (if applicable) may be allowed in accordance with Article 4 of the income tax treaties between the United States and Japan or the United States and the Republic of Korea (South Korea).

Total foreign source income not effectively connected with a U.S. trade or business ▶ $ **N/A**

J Did you file a U.S. income tax return for any year before 2004? ☐ Yes ☑ No
If "Yes," give the latest year and form number ▶

K To which Internal Revenue office did you pay any amounts claimed on Form 1040NR, lines 59, 62, and 64? **N/A**

L Have you excluded any gross income other than foreign source income not effectively connected with a U.S. trade or business? ☑ Yes ☐ No
If "Yes," show the amount, nature, and source of the excluded income. Also, give the reason it was excluded. (Do not include amounts shown in item M.) ▶
$87 US bank interest exempt under IRC §871(i)

M If you are claiming the benefits of a U.S. income tax treaty with a foreign country, give the following information. See page 26 for additional information.
- Country ▶ **Philippines**
- Type and amount of effectively connected income exempt from tax. Also, identify the applicable tax treaty article. Do not enter exempt income on lines 8, 9a, 10a, 11-15, 16b, or 17b–21 of Form 1040NR:
  For 2004 (also, include this exempt income on line 22 of Form 1040NR) ▶ **$10,000 in wages excluded under Article 22(3) of tax treaty between USA and Phillipines**
  For 2003 ▶ **N/A**
- Type and amount of income not effectively connected that is exempt from or subject to a reduced rate of tax. Also, identify the applicable tax treaty article:
  For 2004 ▶ **N/A**
  For 2003 ▶ **N/A**
- Were you subject to tax in that country on any of the income you claim is entitled to the treaty benefits? ☐ Yes ☑ No
- Did you have a permanent establishment or fixed base (as defined by the tax treaty) in the United States at any time during 2004? ☐ Yes ☑ No

N If you file this return to report community income, give your spouse's name, address, and identifying number. **N/A**

O If you file this return for a trust, does the trust have a U.S. business? ☐ Yes ☐ No
If "Yes," give name and address ▶ **N/A**

P Is this an "expatriation return" (see page 26)? ☐ Yes ☑ No
If "Yes," you must attach an annual information statement.

Q During 2004, did you apply for, or take other affirmative steps to apply for, lawful permanent resident status in the United States or have an application pending to adjust your status to that of a lawful permanent resident of the United States? ☐ Yes ☑ No
If "Yes," explain ▶

Printed on recycled paper Form **1040NR** (2004)

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Tax professionals should closely evaluate their alien clients' situation to determine:

1. Whether the alien should be treated as a resident or a nonresident under IRC §7701, and
2. Which income tax form is appropriate to use (Form 1040, 1040NR, or a simpler version).

Alien clients should have the following items of documentation and information available for use in preparing their tax returns:

- Forms W-2, 1099, and 1042-S;
- Current and foreign addresses;
- Scholarship/fellowship grant letters, if applicable;
- Academic institution or host sponsor;
- Passport;
- Visa/immigration status: If the alien is on an F visa, he needs Form DS-2019, *Certificate of Exchange Visitor Status;* if the individual is on a J visa, he needs U.S. entry and exit dates for current and past visits to the United States, plus other applicable documents;
- SSN or ITIN; and
- Form I-20, *Certificate of Student Status*.

RETURN REQUIREMENTS

Resident Aliens

Return requirements differ depending on whether the alien is classified as a resident or nonresident. The IRC treats a resident alien in the same manner as a U.S. citizen. Therefore, the resident alien must use Form 1040. The resident alien is also entitled to itemize deductions or to take the standard deduction and claim an exemption for himself, his spouse, and his dependents who meet the tests for:

- Personal exemptions, and[12]
- Dependents.[13]

A resident alien is further entitled to other tax benefits that are afforded to the U.S. citizen.

Nonresident Aliens

Nonresidents are not entitled to use Form 1040, as used by U.S. citizens and resident aliens. Rather, they must report income and deductions on Form 1040NR or 1040NR- EZ. Allowable deductions and available filing statuses are limited. Other restrictions may also apply.

Form 1040NR includes the following:

- Schedule A for itemizing deductions
- Schedule for reporting tax on income not effectively connected with a U.S. trade or business
- Schedule for reporting visa information, treaty exclusions, and other miscellaneous information

12. IRC §151
13. IRC §152

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Who Must File. Most nonresident aliens present in the U.S. must file Form 1040NR. A nonresident alien must file an income tax return to claim a refund of overwithheld or overpaid tax or to claim the benefit of any deductions or credits. The most common conditions which require filing are:

1. A nonresident alien was engaged in a trade or business in the United States. A nonresident must file **even if:**
   - No income came from a trade or business conducted in the United States,
   - There was no U.S. source income, or
   - The income is exempt from U.S. tax.

Caution. If a nonresident alien is a student, teacher, or trainee and was temporarily present in the United States under an F, J, M, or Q visa, the alien must file Form 1040NR or Form 1040NR-EZ only if he had income (wages, tips, dividends, scholarship and fellowship grants, or other items) specifically required to be reported on Form 1040NR.[14]

2. A nonresident alien was not engaged in a trade or business in the U.S. However, the nonresident alien had income on which the U.S. tax liability was not satisfied by the withholding of tax at the source. This type of income is reported by the payor on information documents including Forms 1042-S and SSA-1042S, and page 4 of Form 1040NR.

   Examples include:
   - Dividends paid by U.S. and foreign corporations,
   - Social security benefits, and
   - Royalties realized by a nonresident alien.
3. Representatives of a deceased person who would have had to file Form 1040NR as described in items 1 or 2.
4. Representatives of an estate or trust that must file Form 1040NR.

Example 4. Chen is a nonresident alien. He has no U.S. business activities during the tax year but had income from real property. Chen elects to treat the income as effectively connected with a U.S. trade or business. Consequently, he must timely file a true and accurate return to claim any allowable deduction against that income.

When to File. Nonresident alien employees who receive wages subject to U.S. income tax withholding are required to file Form 1040NR or 1040NR-EZ by April 15 after the tax year ends. For the 2003 calendar year, the return is due by April 15, 2004.

If a nonresident alien does not receive wages as an employee subject to U.S. income tax withholding, he must file Form 1040NR by June 15 after the tax year ends. For the 2003 calendar year, the return is due by June 15, 2004.

FORM 1040NR

There are differences in the following tax benefits between Form 1040 and Form 1040NR.

Filing Status: Spousal Exemption

Nonresident aliens generally may claim only one personal exemption on Form 1040NR or 1040NR-EZ.[15] However, there are exceptions.

14. IRC §§1, 55 and 871(b)(1)
15. IRC §§151(b) and 873(b)(3)

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Dependency Exemptions

Only U.S. nationals and residents of Canada, Mexico, Japan, and the Republic of Korea (South Korea) may claim exemptions for their dependents. A U.S. national American Samoan, or a Northern Mariana Islander who chooses to be a U.S. national or a resident of Canada or Mexico can claim exemptions for children and other dependents subject to the exemption rules for U.S. citizens. A special treaty benefit exists for certain Indian students or business apprentices.

Deductions

Nonresident aliens are not eligible to take the standard deduction. These individuals must itemize. A nonresident alien may not deduct medical expenses from gross income.[16] Allowable deductions are reported on Schedule A of the Form 1040NR. These deductions include:

- State and local taxes,
- Gifts to U.S. charities,
- Casualty and theft losses,
- Job expenses, and
- Miscellaneous expenses.

Deductible expenses are outlined in Form 1040NR instructions and in IRS Pub. 519. There is an exception for some nonresident aliens from India. The U.S.–India treaty is unique in that it is the only treaty that allows aliens the "standard deduction" privilege.

Example 5. Rafi is a citizen of India. He is in the U.S. on an F-1 visa. He is a full-time student at the University of Illinois. During 2003, Rafi earned $10,000 through his on-campus employment. He files Form 1040NR for the year. Rafi is entitled under the U.S.–India treaty to a standard deduction. This deduction is based on his single filing status. He is also entitled to an exemption for himself.

Note. Aliens are usually well versed on the treaty provisions that apply to them.

TRANSPORTATION INDUSTRY WORKERS

There are special rules and rates applicable to transportation workers. In order to better understand these rules, it is necessary to understand the travel deduction rules in general.

TAX HOME

For travel expenses to be deductible, the worker must be considered to be "away from home." This is defined as away from the worker's tax home:

- For a period longer than a normal workday, and
- For which a period of sleep or rest is necessary.

The determination of the tax home is essential to the deduction of travel expenses. The Rev. Ruls. 60-189 and 73-529 state that a taxpayer's home for purposes of IRC§162(a)**(2)**, is his regular or principal place of business, regardless of the actual location of the residence. The location of the principal place of business includes the entire city or general area in which the taxpayer most often works.

16. Rev. Rul. 56-514

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There are additional guidelines to consider when two or more locations are involved during the tax year:

- **Total time spent** in each area
- **Degree of business activity** in each area
- **Relative amount of income** per area

If the nature of the taxpayer's business is such that there is **no principal place of business,** the tax home may be the **"place of abode" if all three of the following factors are met:**

1. A portion of the business is performed in the vicinity of the residence, while using the residence for lodging.
2. Living expenses are duplicated while away from the residence.
3. The taxpayer either:
   - Has not abandoned the area where his historical residence or claimed residence is located,
   - Has family members currently residing at the claimed residence, or
   - Uses the claimed residence frequently for lodging.

For transportation workers, the tax home is the home terminal where the worker starts and ends his trips.

- For a truck driver, this is the general vicinity of the home terminal.
- For airline workers, this is the airport from which they depart on scheduled flights (this is generally referred to as their home base).
- For train crews, this is the station where the train trips begin and end.

If the transportation worker has no home terminal, but works at several temporary assignments, he may be able to establish his residence as his tax home.[17]

> **Note.** If a transportation worker, without a home terminal, is not able to establish the residence as a tax home, she may be classified as an itinerant worker and barred from deducting any travel expenses.

TEMPORARY VERSUS INDEFINITE

Travel expenses are deductible when a worker is away from his tax home. However, this work assignment must be temporary in nature, rather than indefinite.

Temporary

The IRS defines **temporary** as a job assignment away from home that is realistically **expected to last less than one year.** If the job is expected to last more than one year, the tax home becomes the job location.

Indefinite

Rev. Rul. 93-86 states **if the work is expected to last more than one year, it is classified as indefinite,** even if the assignment subsequently ends prior to one year.

> **Example 6.** Steve works for Lemon Computers, Inc., in Kansas City. He is reassigned to St. Louis for 14 months to open a new retail store. After nine months, the new location is not profitable and closes. Steve returns to the Kansas City store. Even though he was away from home less than one year, his away-from-home expenses are not deductible because the **original assignment was for more than one year.**

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17. *C.W. Todd v. Commr.,* 3 TCM 1221, November 20, 1944

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> **Note.** See pages 611–612 of the *2003 University of Illinois Federal Tax Workbook*. The *Brockman* court case is described, which has a contrary result.

SUBSTANTIATION REQUIREMENTS

The Code does not allow for travel expenses (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements.[18] Substantiation requirements include adequate records or evidence that corroborates the taxpayer's own statement including the following:

- Amount
- Time and place
- Business purpose
- Business relationship of the expense

Therefore, good recordkeeping is essential as proof of valid deductions. Important items to document and retain include:

- Lodging receipts, unless the per diem method is used. Actual lodging expenses are deductible, even in excess of the federal rate if documentation is provided.
- Sleep or rest period requirements. This means logging time spent away from home, which need not be for a full 24-hour period.

For other travel expenses under $75, original receipts are not necessary. However, the taxpayer should document the expenses in a diary or log book consistently with the previously-listed substantiation requirements.[19]

Under an accountable plan, reimbursements received by an employee need not be included on Form W-2, nor reported on the employee's tax return. **Three conditions are required for a plan to qualify as an accountable plan.**

1. A business purpose must exist.
2. The expenditures must be substantiated or deemed substantiated.
3. Excess reimbursements or allowances must be returned to the employer.

SUBSTANTIATION METHODS

In addition to the actual expense method, two optional methods of substantiating certain travel expenses are available; the federal per diem rate and the high-low method.

1. Federal Per Diem Rate

Some recordkeeping requirements may be alleviated by using the per diem method. This method is used to calculate the deductible amount of meals, lodging, and incidental expenses without creating actual cost records.

If taxpayers comply with the per diem requirements, they are deemed to comply with the adequate records substantiation requirements. However, the other elements of substantiation, such as place and purpose, still must be documented.

Employees use the per diem method quite often, but self-employed persons and independent contractors may also use this method.

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18. IRC §274(d), as mentioned in Rev. Proc. 2003-80, Sec. 2.03

19. Treas. Reg. §1.274-5(c)(2)(iii)(A)(2)

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The per diem method involves using the federal per diem rate (or the published rate, if higher) to calculate the deduction for meals, lodging, and incidentals while traveling. For travel after October 1, 2003, the federal rate is $86, which includes $31 for meals and incidental expenses (M&IE). Table 4 of IRS Pub. 1542, *Per Diem Rates for Travel within the Continental United States,* lists over 500 locales which are entitled to a higher rate.

The government publishes per diem tables under the Federal Travel Regulations for areas within the continental United States (CONUS) and areas outside the continental United States (OCONUS), such as Alaska and Hawaii. These tables can be obtained from a link on the General Services Administration website at **www.policyworks.gov.** The per diem tables have historically been published each year from October 1 to September 30.

Note. A partial listing from this table is included later in this section.

In April 2004, the IRS announced that it was initiating a new schedule for the release of both the federal per diem and high-low per diem rates. Taxpayers could begin using the new rates as soon as they were released. The IRS announcement stated:

During the year, as changes to the federal per diem rates (updates) are announced by the General Services Administration (GSA), the IRS incorporates the changes into IRS Pub. 1542. A "What's Hot" article on the IRS website alerts taxpayers to locales having updated rates. The new rates are found in Table 4 of the revised publication. The "What's Hot" articles are found by going to the IRS website (www.irs.gov/formspubs) and clicking on "What's Hot in Tax Forms, Pubs and Other Tax Products", and then clicking on the link provided under "Changes to Our Current Tax Products."

Annual changes for both the federal per diem and high-low rates are incorporated into IRS Pub. 1542 as soon as possible after being announced by the GSA and the IRS. The annual issue of the publication is available each year in mid- to late-October.

2. High-Low Method

The high-low method uses a per diem rate established by the IRS. The high rate applies to locations identified by the IRS as high-cost areas; the low rate applies to all other CONUS locations. The applicable rates for November 1, 2003, through September 30, 2004 are shown.

Cost	Total Per Diem	Lodging Portion	M&IE Portion	Incidental Expenses Only
High	$207	$161	$46	$3
Low	126	90	36	3

The names of the high-cost locations are found in IRS Pub. 1542, Table 2. It should be noted that the same method must be used throughout the entire calendar year.

Caution. The per diem method (for lodging, meals, and incidentals) cannot be used where the payor and the payee are related within the meaning of IRC §267(b), using a 10% common ownership standard. These employees must substantiate actual expenses or use the meals-only per diem and/or the standard mileage rate.

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Deduction Availability

Taxpayer Types	Hi/Low	Lodging Expense		Meal Expense	
		Actual	Per Diem	Actual	Per Diem
Self-employed deduction	No	Yes	No	Yes	Yes
Nonreimbursed employees 20% deduction	No	Yes	No	Yes	Yes
Reimbursed employees Deductible to employer, except 10%	Yes	Yes	Yes	Yes	Yes

INCIDENTAL EXPENSES

Incidental expenses are a part of the M&IE rates. Incidentals are defined as tips to porters, baggage carriers, bellhops and hotel maids.[20] Expenses for laundry, cleaning, ironing, taxi fares, lodging taxes and telephone calls are not incidental and may be deducted separately if substantiated. The taxpayer may deduct $3 per day for any day of travel that does not rely on a per diem or M&IE rate.

Traveling away from home may necessitate the use of cell phones. When used for business purposes this is a deductible expense. A portion of the cost should be allocated to personal use.

SPECIAL TRANSPORTATION WORKER RULES

Historically, transportation workers were those employees and independent business owners subject to the Department of Transportation (DOT) hours of service limitations. However, Rev. Proc. 2003-80 reworded the definition of a "transportation worker" to read:

An employee or self-employed individual is in the transportation industry only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing federal M&IE rates.

Examples of transportation workers include:

- Specific air transportation employees subject to Federal Aviation Administration (FAA) regulations such as pilots, crew, dispatchers, mechanics, and control tower operators;
- Interstate truck operators and interstate bus drivers;
- Railroad workers, such as engineers, conductors, train crews, dispatchers, and control operations personnel; and
- Merchant mariners, subject to Coast Guard regulations.

The employer who hires transportation workers and self-employed transportation workers is also entitled to special tax benefits.

Per Diem Rate

Transportation workers may use a MI&E rate of $41 for CONUS and $46 for OCONUS for the period October 1, 2003 to September 30, 2004.[21]

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20. Rev. Proc. 2003-80 Sec. 3.02(3), 2003-45 I.R.B. 1037

21. Rev. Proc. 2003-80

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Whereas nontransportation industry workers can only deduct 50% of the amount of meal expenses, qualified transportation workers can deduct the following percentages for meal expenses:

Tax Year	Deductible Percentage
2003	65%
2004 and 2005	70%
2006 and 2007	75%
2008 and later	80%

This emphasizes not only the importance of correctly classifying a worker as being in the transportation industry but also the need to correctly separate meal expense from other travel expenses.

Other Expenses

Truck drivers also may incur "lumper" fees. These are fees paid to individuals at the loading docks who help load and unload cargo. Although it is unlikely any one person would be paid over $600, if this occurs, a Form1099 must be issued. Regardless of whether the 1099 is issued, the expense must be properly documented.

Caution. Section 4.04(2) of Rev. Proc. 2003-80 contains a transition rule. Under the calendar-year convention, a taxpayer who used the federal M&IE rates during the first 10 months of calendar year 2003 to substantiate the amount of his travel expenses has certain restrictions. He may not use the special transportation industry rates provided in section 4.04 ($41 and $46) until January 1, 2004. Similarly, a taxpayer who used the special transportation industry rates during the first 10 months of calendar year 2003 to substantiate the amount of travel expenses may not use the federal M&IE rates until January 1, 2004.

Expenses for Traveling Companions

The travel expenses of a spouse, dependent, or other individual may not be deducted unless there is a bona fide business purpose for their expenses. The cost of travel does not have to be divided in half. The portion considered personal is the amount over and above the single rates.

Example 7. Marsha's spouse accompanies her to a convention. The hotel rate for a double room is $120, and the single rate is $100. The $100 is deductible for lodging. The entire amount of car expense is deductible; however, the husband's meals are not deductible

Guard dog expenses are allowable when the business purpose can be substantiated as an ordinary and necessary business expense. The taxpayer must be able to prove that the purpose of the guard dog is to protect the owner's business property rather than his person.

SPECIAL ISSUES FOR TRUCKERS

The Tax Court ruled that a trucking company which computes per diem on a basis similar to the method used to compute employee's wages must count the entire per diem amount as M&IE. The company was not allowed to attribute any portion to lodging.[22] Therefore, full per diem rates are subject to the percentage limitation. In the *Boyd* case, the trucking company, operating as an S corporation, paid its long-haul drivers a per diem allowance of 9¢ per mile. The drivers were not required to submit receipts for actual travel expenses. The drivers' wages were also calculated on a per-mile basis. Electing Rev. Proc. 96-64 would therefore waive the requirement of actual substantiation. The revenue procedure further states that this election allows the entire per diem to be treated as meals and incidental expenses. The court noted the use of the per diem method was to reduce record keeping for the trucking firm and therefore it must abide by the rules contained in the revenue procedure.

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22. *Charles A. Boyd and Darby A. Harvey, f.k.a. Darby A. Boyd, et al. v. Commr.,* TC, April 27, 2004

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> **Note.** If the amount of the payment exceeds the federal rate for M&IE for the locality in which the truck driver is traveling, any excess per diem is not considered substantiated and must be included in income.

Truckers are most likely aware of a trend by state revenue departments to attempt to apply nexus (location) with trucking firms. Each state has a different definition of what creates nexus in its state. A trucker may have a nexus with a state based on:

- The number of loaded miles he's traveled in that state,
- The number of trips for pick-ups or deliveries he's made in the state, or
- A percentage of his total loaded miles within that state.

Once nexus is met for a given state, a taxpayer must file an income tax return, and income allocated to that state must be taxed at that state's rate.

Example 8. Snowman Trucking, Inc., is located in Illinois. It hauls loads to several states, one of which is Pennsylvania. During calendar year 2004, Snowman Trucking carried more than 12 deliveries to locations in Pennsylvania. Under the laws of Pennsylvania, nexus has been created. Not only is a corporate tax return due to the state of Pennsylvania, but the corporation must also register as a foreign corporation doing business in Pennsylvania. The same analysis must be made for every state to determine filing requirements.

SELECTED PER DIEM RATES

The following table contains a few of the federal per diem rates. The purpose of this listing is to identify the amount of variance between locations.

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2004 Workbook

FY2004 Domestic Per Diem Rates — Effective October 1, 2003

State	Destination	County and/or Other Defined Location	Seasonal Dates	FPLP	Maximum Lodging Rate (excludes taxes)	M&IE Rates	Maximum per Diem Rate
Standard CONUS Rate					**$ 55**	**$31**	**$ 86**
AL	Gulf Shores	Baldwin	May 15–September 4		101	39	140
AZ	Phoenix/Scottsdale	Maricopa	January 1–April 15	X	107	47	154
AZ	Phoenix/Scottsdale	Maricopa	April 16–May 31	X	79	47	126
AZ	Phoenix/Scottsdale	Maricopa	June 1–August 31	X	59	47	106
AZ	Phoenix/Scottsdale	Maricopa	September 1–December 31	X	90	47	137
CA	San Francisco	San Francisco		X	139	51	190
CO	Denver	Denver, Adams, and Arapahoe Counties, that portion of Westminster located in Jefferson County, and Lone Tree in Douglas County		X	112	47	159
CT	Hartford	Hartford			120	43	163
FL	Naples	Collier	December 16–April 15		130	43	173
FL	Naples	Collier	April 16–December 15		73	43	116
IL	Chicago	Cook and Lake		X	155	51	206
MA	Martha's Vineyard	Dukes	June 1–October 15		150	47	197
MA	Martha's Vineyard	Dukes	October 16–May 31		85	47	132

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FOSTER AND ADULT CARE PROVIDERS

DEFINITIONS

Qualified Foster Individual

A **qualified foster individual** is any person who is living in a foster family home in which he was **placed by a state agency or a qualified foster care placement agency.**[23] Prior to 2002, if an entity other than a state licensed tax-exempt entity, such as a health maintenance organization, placed an individual in a foster home, he was not considered a qualified foster individual.

Qualified Placement Agency

A qualified placement agency is one which is licensed or certified by a state or its political subdivision or an entity designated by the state. The agency administers the foster care program and makes the foster care payments to the foster care providers.[24]

Providers

- **Foster care providers (caregivers)** care for children and adults in their homes.
- **Respite care providers** help caregivers by caring for their foster children or adults while the caregiver takes time off.

> **Note.** When foster care providers employ others to help care for foster children or adults, qualified payments are made to the **employer**, not to the employees providing the care.

TYPES OF INCOME

Payments are made to both foster care providers (caregivers) and respite care providers. Foster care payments are made to the caregivers who directly care for the foster individual. Respite care payments are made to the respite care provider who cares for foster individuals while the caregiver is away for a period of time.

Tax Exempt

As an apparent incentive to encourage more caregivers, Congress designated certain types of caregiver income as tax exempt.[25] For a payment to qualify as tax exempt, it must be considered a qualified foster care payment. **A qualified foster care payment is identified as any payment made under a government foster care program.**

For payments made after 2001, there are two types of payments qualifying for tax-exempt treatment:

1. Qualified foster care payments
2. Difficulty of care payments[26]

Qualified foster care payments include those made by a **qualified foster care placement agency** to a caregiver for caring for a qualified foster individual in the caregiver's home.[27] For the payment to be tax exempt, the caregiver must reside in the home where the care is provided.

23. IRC §131(b)(2)
24. IRC §131(b)(3)
25. IRC §131
26. IRC §131(b)(1)(B)(i) and (ii)
27. IRC §131(b)(1)

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Difficulty of care payments are made to caregivers who provide additional care for a qualified foster care individual. The payment results from the state's determination that the individual needs additional compensation for a physical, mental, or emotional handicap. The payor must make this designation. Again, the caregiver must reside in the home where the care is provided. These payments are tax exempt if they are made for:

- Ten or fewer individuals who are younger than 19 years old, or
- Five or fewer individuals who are 19 years or older.

Qualified Foster Care Payments. For tax years after 2001, a tax-exempt foster care payment must meet the following requirements. The payment must be made:

- To a caregiver for caring for a qualified foster individual in the caregiver's home,
- Under the foster care program of a state or its political subdivision, and
- By the state or its political subdivision, or by a qualified foster care placement agency.

Caution. It is imperative that the caregiver reside in the home where the care is provided. In 1998, the Tax Court ruled that taxpayers who owned four residential houses and provided foster care for adults could not exclude from income those state assistance payments received for foster care performed at the three houses where they did not reside.[28] An earlier letter ruling also reached the same conclusion.[29]

Taxable

Foster Care Payments. Foster care payments are taxable to the extent that they are made for more than five qualified foster care individuals who have reached age 19.[30] Payments to foster care providers are taxable if they are intended to keep emergency shelter care available and are not dependent upon the presence of a qualified foster individual.

Difficulty of Care Payments. Difficulty of care payments are taxable to the extent they are made for more than 10 individuals who have not attained age 19.[31] These payments are also taxable to the extent that they cover more than five qualified foster care individuals who have attained age 19.[32]

Respite Care Payments. Respite care payments are taxable, even if the provider is certified by a state as a qualified foster care provider.[33]

Resident's Payments. Payments received directly from residents receiving services or their representatives are taxable and must be included in the caregiver's gross income. This includes SSI or social security payments which the residents receive and then pay to the caregiver.

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28. *Pavel and Ana Dobra v. Commr.,* 111 TC 339, December 29, 1998
29. Letter Ruling 9429004, April 8, 1994
30. IRC §131(b)(4)
31. IRC §131(c)(2)(A)
32. IRC §131(c)(2)(B)
33. Chief Counsel Advice 200347004, August 6, 2003

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TYPES OF DEDUCTIONS

Foster caregivers must classify their expenses into two categories. The first is operating expenses and the second is lodging expenses.

1. **Operating Expenses.** Operating expenses are those attributed directly to the individual(s) receiving care. These include items such as food, clothing, employee wages, and supplies. These expenses must be allocated between taxable and tax-exempt income. The expenses allocated to taxable income are fully deductible. Any expense attributable to tax-exempt income is not deductible.[34]

2. **Lodging Expenses.** Lodging expenses follow the same rules as those a taxpayer uses for an office-in-home deduction. A taxpayer may deduct a portion of his principal residence expenses if he uses part of the residence for exclusive, regular use as a trade or business.[35] The Code also allows a portion of the home to be deducted, even if it is not used exclusively for business, if it is used to provide daycare for individuals who are children, adults who have reached age 65, or for individuals who are mentally or physically unable to care for themselves.[36] This exception only applies if the service is **not** provided on a continuous 24/7 basis.[37] For foster care deductions for room and board, IRC §280A(c)(1) applies. Only the exclusive, regular-use portion is allowable in computing room and board deductions.

Example 9. Kent and KC operate a 24/7 care facility in their residence. A state agency licenses their home as a qualified care facility for mentally and physically challenged individuals. KC and Kent receive $1,000 per month payments from the agency for each of the eight children they have residing in their home. They also have four residents who do not receive payments from the state. These residents are also charged $1,000 per month. KC and Kent both live in the home that they use for the facility. Their income and expense for 2004 is as follows:

Income			
Payments from state	$ 96,000		
Private payments	48,000		
Total income			$144,000
Operating expenses			
Actual food cost for residents	$ 6,000		
Wages for employees	12,000		
Supplies	5,000		
Total operating expenses		$23,000	
Office-in-home expenses			
Interest on home mortgage	$ 6,500		
Property tax	2,000		
Repairs	2,500		
Depreciation	1,000		
Insurance	800		
Utilities	3,600		
Total office-in-home expenses		16,400	
Total expenses			(39,400)
Net profit			$104,600

34. Treas. Reg. §1.265-1(c)

35. IRC §280A(c)(1)

36. IRC §280A(c)(4)(A)

37. Prop. Treas. Reg. §1.280A-2(f)(2)

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Kent and KC's home is 4,100 square feet, with 1,400 square feet exclusively used by the residents, which includes bedrooms and bathrooms. The dining room, kitchen, and living room total 1,500 square feet. This area is used by both the residents and Kent and KC. The remaining 1,200 square feet are exclusively used by Kent and KC.

The percentage of Kent's and KC's tax-exempt income limits their deductions to their percentage of taxable income. The taxable income percentage is 33.33% ($48,000 taxable income ÷ $144,000 total income).

Operating expense deduction = $23,000 × 33.33% = $7,667

Following IRC §280A(c)(1), KC and Kent cannot include the 1,200 square feet of their personal-use area and the 1,500 square feet of common use area for computing the office-in-home deduction, since both areas fail the exclusive-use test. Only the 1,400 square feet used exclusively by the residents is permissible to use when computing the office-in-home deduction. The exclusive use percentage is 34.15% (1,400 exclusive use ÷ 4,100 total). The operating expense deduction is further limited by the exclusive use percentage.

Office-in-home deduction = $16,400 × 33.33% × 34.15% = $1,866

Kent and KC's net taxable income is calculated as follows:

Income		**Tax-exempt**		**Taxable**	
Payments from state	$ 96,000		$96,000		
Private payments	48,000				$48,000
Total income	$144,000		$96,000		$48,000
Operating expenses		**Nondeductible**		**Deductible**	
Actual food cost for residents	$ 6,000				
Wages for employees	12,000				
Supplies	5,000				
Total operating expenses	$ 23,000	$15,334		$ 7,667	
Office-in-home expenses					
Interest on home mortgage	$ 6,500				
Property tax	2,000				
Repairs	2,500				
Depreciation	1,000				
Insurance	800				
Utilities	3,600				
Total office-in-home expenses	$ 16,400	$14,533		$ 1,866	
Total expenses	(39,400)	$29,867	(29,867)	$ 9,533	(9,533)
Net profit	$104,600		$66,133		$38,467

Kent and KC's completed 2004 Schedule C and Form 8829 follow.

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For Example 9

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.

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

OMB No. 1545-0074 **2004** Attachment Sequence No. **09**

Name of proprietor: **KENT SMITH** | Social security number (SSN): **222 22 2222**

A Principal business or profession, including product or service (see page C-2 of the instructions): **ADULT DAYCARE**

B Enter code from pages C-7, 8, & 9 ▶ **6 2 4 1 0 0**

C Business name. If no separate business name, leave blank.: **ABC ADULT DAYCARE**

D Employer ID number (EIN), if any: **4 4 4 4 4 4 4 4 4**

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: (1) ☑ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2004? If "No," see page C-3 for limit on losses ☑ Yes ☐ No

H If you started or acquired this business during 2004, check here ▶ ☐

Part I Income

Line	Description		Amount
1	Gross receipts or sales. **Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ▶ ☐	1	48,000
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	48,000
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	48,000
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	48,000

Part II Expenses. Enter expenses for business use of your home only on line 30.

Line	Description	Amount	Line	Description	Amount
8	Advertising		19	Pension and profit-sharing plans	
9	Car and truck expenses (see page C-3)		20	Rent or lease (see page C-5):	
10	Commissions and fees		20a	a Vehicles, machinery, and equipment	
11	Contract labor (see page C-4)		20b	b Other business property	
12	Depletion		21	Repairs and maintenance	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)		22	Supplies (not included in Part III)	1,667
14	Employee benefit programs (other than on line 19)		23	Taxes and licenses	
15	Insurance (other than health)		24	Travel, meals, and entertainment:	
16	Interest:		24a	a Travel	
16a	a Mortgage (paid to banks, etc.)			b Meals and entertainment	
16b	b Other			c Enter nondeductible amount included on line 24b (see page C-5)	
17	Legal and professional services		24d	d Subtract line 24c from line 24b	
18	Office expense		25	Utilities	
			26	Wages (less employment credits)	4,000
			27	Other expenses (from line 48 on page 2) **Food**	2,000

Line	Description		Amount
28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	7,667
29	Tentative profit (loss). Subtract line 28 from line 7	29	40,333
30	Expenses for business use of your home. Attach **Form 8829**	30	1,866
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you **must** go to line 32.	31	38,467

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
• If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you **must** attach **Form 6198.**

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P **Schedule C (Form 1040) 2004**

Draft as of 05/05/2004

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For Example 9

Form **8829** Department of the Treasury Internal Revenue Service	**Expenses for Business Use of Your Home** ▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year. ▶ See separate instructions.	OMB No. 1545-1266 **2004** Attachment Sequence No. **66**

Name(s) of proprietor(s)	Your social security number
KENT SMITH	222 22 2222

Draft as of 05/05/2004

Part I — Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for day care, or for storage of inventory or product samples (see instructions)	1	1,400
2	Total area of home	2	4,100
3	Divide line 1 by line 2. Enter the result as a percentage	3	34.15 %
	• **For day-care facilities not used exclusively for business, also complete lines 4–6.**		
	• **All others, skip lines 4–6 and enter the amount from line 3 on line 7.**		
4	Multiply days used for day care during year by hours used per day — 4: hr.		
5	Total hours available for use during the year (366 days × 24 hours) (see instructions) — 5: 8,784 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount — 6: .		
7	Business percentage. For day-care facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶	7	34.15 %

Part II — Figure Your Allowable Deduction

			(a) Direct expenses	(b) Indirect expenses		
8	Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions				8	40,333
	See instructions for columns (a) and (b) before completing lines 9–20.					
9	Casualty losses (see instructions)	9				
10	Deductible mortgage interest (see instructions)	10		2,165		
11	Real estate taxes (see instructions)	11		666		
12	Add lines 9, 10, and 11	12		2,831		
13	Multiply line 12, column (b) by line 7	13		967		
14	Add line 12, column (a) and line 13				14	967
15	Subtract line 14 from line 8. If zero or less, enter -0-				15	39,366
16	Excess mortgage interest (see instructions)	16				
17	Insurance	17		266		
18	Repairs and maintenance	18		833		
19	Utilities	19		1,199		
20	Other expenses (see instructions)	20				
21	Add lines 16 through 20	21		2,298		
22	Multiply line 21, column (b) by line 7	22		785		
23	Carryover of operating expenses from 2003 Form 8829, line 41	23				
24	Add line 21 in column (a), line 22, and line 23				24	785
25	Allowable operating expenses. Enter the **smaller** of line 15 or line 24				25	785
26	Limit on excess casualty losses and depreciation. Subtract line 25 from line 15				26	38,581
27	Excess casualty losses (see instructions)	27				
28	Depreciation of your home from Part III below	28		114		
29	Carryover of excess casualty losses and depreciation from 2003 Form 8829, line 42	29				
30	Add lines 27 through 29				30	114
31	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 26 or line 30				31	114
32	Add lines 14, 25, and 31				32	1,866
33	Casualty loss portion, if any, from lines 14 and 31. Carry amount to **Form 4684,** Section B				33	
34	Allowable expenses for business use of your home. Subtract line 33 from line 32. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶				34	1,866

Part III — Depreciation of Your Home

35	Enter the **smaller** of your home's adjusted basis or its fair market value (see instructions)	35	13,000
36	Value of land included on line 35	36	
37	Basis of building. Subtract line 36 from line 35	37	13,000
38	Business basis of building. Multiply line 37 by line 7	38	4,440
39	Depreciation percentage (see instructions)	39	2.5640 %
40	Depreciation allowable (see instructions). Multiply line 38 by line 39. Enter here and on line 28 above	40	114

Part IV — Carryover of Unallowed Expenses to 2005

41	Operating expenses. Subtract line 25 from line 24. If less than zero, enter -0-	41	0
42	Excess casualty losses and depreciation. Subtract line 31 from line 30. If less than zero, enter -0-	42	0

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REAL ESTATE PROFESSIONALS

INTRODUCTION

One of the more interesting and misunderstood tax issues facing tax professionals every year is passive income and passive loss. With the Tax Reform Act of 1986, Congress eliminated the deduction of tax losses from activities in which taxpayers were not directly involved. However, new complexities were created. Caught in the middle of the passive income/passive loss issue are rental activities, which Congress simply labeled **passive.**

Most practitioners have clients who own rental property. Since 1987, practitioners have dealt with tax issues such as the $25,000 special allowance rule, income limitations, "active participation," limited partners, and more. Clients who are real estate professionals pose a challenge in this area of tax law. Many tax professionals, including the IRS, have incorrectly handled the issue of real estate professionals.

In the last several years, numerous court cases concerning real estate professional issues have been decided in favor of the IRS. In light of these cases and the IRS's interest in this issue, this section provides an in-depth review of the Real Estate Professional Rules.

Note. This discussion will surprise many readers. Practitioners may recommend that their affected clients make an "election" in 2004 to treat all of the taxpayers' interests in rental real estate as a single real estate activity. Passive activities and losses are discussed in Problem 7 of Chapter 1, Individual Problems.

THE ISSUE

Rental property owners who qualify as "real estate professionals" are not subject to the passive activity loss limitations for their rental real estate activities.[38] This includes the $25,000 maximum deduction for individuals with adjusted gross income (AGI) of $100,000 or less. Therefore, losses resulting from rental properties are deductible in full and can be used to offset both active and portfolio income. Schedule E, *Supplemental Income and Loss,* page 2, line 43 is used to report the income or loss that is attributable to the real estate professional.

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	

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The Real Estate Professional Rule impacts **only** the current deductibility of Schedule E rental real estate losses. IRC §469(c)(7) has no impact on the individual's Schedule C. Some practitioners argue that by claiming the benefits of this code section, the taxpayer must treat the sale of his rental properties as ordinary income subject to social security taxes. Other practitioners voice the concern that use of this code section results in dealer status for the taxpayer. **None of these concerns are valid.** There is no connection between §469(c)(7) and these other provisions in the Code or Regulations.

38. IRC §469(c)(7)

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> **Note.** IRC §469(c)(7) is titled "Special rules for taxpayers in real property business." The term *real estate professional* is not found in the Code or the Regulations. However, the term is used informally to identify the type of person to whom the benefits of this section apply. Both the IRS (Market Segment Specialization Program) guidelines and Schedule E, page 2, line 43 of Form 1040 refer to the term "real estate professionals."

Internal Revenue Code

In order to understand the issues for the real estate profession, an analysis of the Code and Regulations is necessary. IRC §469 limits the deductions and credits for losses from passive activities, and §469(c)(2) defines rental activities as passive, except as provided in paragraph (7):

(7) Special rules for taxpayers in real property business.

(A) In general. If this paragraph applies to any taxpayer for a taxable year—

(i) Paragraph (2) shall not apply to any rental real estate activity of such taxpayer for such taxable year, and

(ii) This section shall be applied as if each interest of the taxpayer in rental real estate were a separate activity.

Notwithstanding clause (ii), a taxpayer may elect to treat all interests in rental real estate as one activity. Nothing in the preceding provisions of this subparagraph shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner.

(B) Taxpayers to whom paragraph applies. This paragraph shall apply to a taxpayer for a taxable year if—

(i) More than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

(ii) Such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements.[39]

IRS Regulations

Treas. Reg. §1.469-9(e):

(e) Treatment of rental real estate activities of a qualifying taxpayer

(1) In general. --Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. ***Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity.***[40] *Each interest in rental real estate of a qualifying taxpayer will be treated as a separate rental real estate activity, unless the taxpayer makes an election under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity. Each separate rental real estate activity, or the single combined rental real estate activity if the taxpayer makes an election under paragraph (g), will be an activity of the taxpayer for all purposes of section 469, including the former passive activity rules under section 469(f) and the disposition rules under section 469(g). However, section 469 will continue to be applied separately with respect to each publicly traded partnership, as required under section 469(k), notwithstanding the rules of this section.*

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39. IRC §469(c)(7)(A) and (B)

40. Bold emphasis is made by the author and is not included in the regulations.

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Observation. To qualify as a real estate professional, the taxpayer must meet both the "one-half of personal services" and the "more than 750 hours per year" tests. He must also materially participate in the rental real estate activity.

IRS GUIDELINES

The IRS creates various publications covering specific types of taxpayers. These publications are used by IRS auditors to help them understand the businesses they are examining. The following excerpt is from the IRS Market Segment Specialization Program (MSSP) Guidelines (Passive Activity Losses, February 1996), Chapter 2, subsection on real estate professionals.

Beginning with the 1994 year, a taxpayer who meets ALL of the following can deduct current rental real estate losses in full regardless of how high his AGI might be:

1. More than half of the taxpayer's personal services in all businesses must be in real property businesses. A real property business is real property development, construction, acquisition, conversion, rental, management, leasing, or brokerage.

2. The taxpayer must spend more than 750 hours a year in real property trades or businesses.

NOTE. For time to be counted in either of the above two tests, the taxpayer must materially participate in the activity.

3. The taxpayer must materially participate in EACH rental real estate activity unless he has filed an election to group all rental real estate activities as one (for purposes of materially participating).[41]

For the first two tests, each spouse's time is taken into account separately. Thus, one spouse alone must satisfy the personal services and 750 hour requirements.

For the third test, both spouses' time together can be counted, but only time applied to the rental real estate activity (and not to the real property business) is counted. It is important to note that even if the taxpayer meets all of the requirements and can deduct current rental real estate losses in full, prior year suspended losses remain passive. Some taxpayers incorrectly thought that meeting the requirements of IRC §469(c)(7) triggered the deductibility of prior year suspended losses.

It should also be noted that these rules are not elective. Some taxpayers may meet the three tests with the result that their net rental income will be nonpassive and, consequently, the income cannot be used to offset other passive losses, such as limited partnership losses, for example.

41. Bold emphasis is made by the author and is not included in the MSSP guidelines.

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ANALYSIS

The taxpayer must expend more than one-half of his trade or business personal services during a tax year in a trade or business which constitutes a real property trade or business. The Code specifically lists those qualifying real property trades or businesses as any of the following:

- Real property development
- Redevelopment
- Construction
- Reconstruction
- Acquisition
- Conversion
- Rental
- Operation
- Management
- Leasing
- Brokerage trade or business[42]

While the Code does not indicate how one-half is measured, the IRS MSSP guidelines specifically refer to "time" spent. "Personal services" are defined as any work performed by an individual in connection with a trade or business, not including work performed in the capacity of an investor.[43]

The regulations address recordkeeping to substantiate the amount of time needed to satisfy the "more than one-half" and the "more than 750 hours" rules:

The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.[44]

THE MISUNDERSTANDING

Since 1994, when the Real Estate Professional Rule became law, most tax professionals felt their full-time realtor clients, who also owned rental real estate properties, automatically qualified. They based this on the fact that:

- Realtors materially participate in the real estate business due to their sales activities, and
- The 750-hour minimum annual time requirement is easily met since realtors are involved full-time in real estate.

Consequently, Schedule E rental losses of many realtors have been fully deducted against both active and portfolio income.

The misunderstanding arises out of "material participation" as defined in the regulations. The regulations clearly require material participation in the **rental** real estate activity**, not just the real estate business.** So what is material participation?

42. IRC §469(c)(7)(C)

43. Treas. Reg. §1.469-9(b)(4)

44. Temp. Treas. Reg. §1.469-5T(f)(4)

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Material participation is defined in the Code as:

> *(1) In general. A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is—*
>
> > *(A) regular*
> >
> > *(B) continuous, and*
> >
> > *(C) substantial.*[45]

The definition of material participation is further expanded in the Regulations:

> *(a)* ***In general.*** *—Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if —*
>
> > *(1) The individual participates in the activity for more than 500 hours during such year;*
> >
> > *(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;*
> >
> > *(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;*
> >
> > *(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;*
> >
> > *(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;*
> >
> > *(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year;* ***or***
> >
> > *(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.*

Note. Only one of these tests must be met.

These regulations make it very difficult to meet the material participation standard for a rental real estate activity. Not many rental property owners spend over 500 hours per year, or an average of 40 hours per month, managing their property(s). Consider the following example:

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[45] IRC §469(h)

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Example 10. Helen operates a busy real estate practice as a sales associate with Zip Realty. Helen earns in excess of $220,000 in commission income per year, with an average net profit on Schedule C of $155,000. Helen is a full-time realtor, and this is her only trade or business. Helen easily meets the 750 hour annual requirement for real estate professionals.

Helen also owns a nine-unit apartment building. In 2004, her Schedule E reflects a rental loss of $13,967. She uses an area property management company to manage the building. Because her AGI is over $150,000, she cannot deduct the loss unless she qualifies under the Real Estate Professional Rules.

Helen spent 30 hours during the year reviewing management reports and meeting with her property manager. She had no other involvement either in the current year or prior years.

Question A. Is the $13,967 loss currently deductible by Helen under the Real Estate Professional Rule?

Answer A. No. Helen's involvement in the management of the rental activity does not meet any of the seven material participation standards.

Question B. Would the answer in **Question A** be the same if Helen managed the building herself?

Answer B. Maybe. Helen should carefully document the time she spends managing the building to see if she can meet one of the seven tests.

Caution. It would be difficult for any real estate professional to meet the material participation standards for just one property, unless they to do all of its maintenance and management.

In addition to the material participation requirement, there is another requirement that is often overlooked. Unless an election is made to the contrary, **each interest of the taxpayer in rental real estate is required to be treated as a separate activity.**[46]

Example 11. Assume the same facts as **Example 12** except, Helen owns **seven rental properties.** The rental properties reflect a total 2004 Schedule E loss of $32,819.

Question A. Can Helen claim this total loss on her 2004 return?

Answer A. No. While Helen is probably closer to meeting one of the material participation tests, the Code and Regulations make it clear that the material participation tests must be met for "each interest of the taxpayer in a rental real estate activity." Since Helen has seven interests in rental real estate, she must materially participate in each property in order to qualify for the 2004 deduction of the loss attributable to that property.

The word **"each"** in the Code is the key to the confusion regarding the deductibility of rental property losses. Two recent court decisions focused on this point in disallowing rental real estate losses to otherwise qualifying real estate professionals.

In *Jahina*, the Court stated: "Jahina must qualify as a real estate professional with respect to each property separately in order to avoid a determination that the rental activities were per se passive under section 469(c)(2)."[47]

In *Hajiyani*, the Court found that the taxpayer's "vague testimony" regarding the time spent managing his rental properties, either individually or in the aggregate, was insufficient to support his claim of being a real estate professional.[48]

These two cases are discussed later in this section.

---

46. IRC §469(c)(7)(A)(ii)

47. *Jahina v. Commr.*, TC Summary Opinion 2002-150, November 21, 2002

48. *Hajiyani v. Commr.,* TC Summary Opinion 2001-183, December 12, 2001

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> **Note.** In neither case was the election to aggregate the various interests in real estate made by the taxpayers. In *Jahina*, the court relied on the lack of a specific election by the taxpayer. In *Hajiyani*, the court relied entirely on the lack of recordkeeping and never had to decide on the election issue, other than the wording "individually or in the aggregate."

Question B. Is there anything Helen can do to make losses from her seven rental properties deductible in 2004 and future years?

Answer B. Yes. Helen can make an **election** on her 2004 return under IRC §469(c)(7)(ii) to treat all interests in rental real estate as one activity.

MAKING THE ELECTION

An election to treat all interests in rental real estate as one activity falls under IRC §469(c)(7)(ii). The Regulations provide guidance on the process for making the election.

Election to Treat All Interests in Rental Real Estate as a Single Rental Real Estate Activity:

In general. *A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year.*

Filing a statement to make or revoke the election. *A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). A taxpayer may make this election for any taxable year in which section 469(c)(7) is applicable.*[49]

Sample Election Wording

> Election to Treat All Real Estate Interests as One Activity
> IRC §469(c)(7)(A) and Treas. Reg. §1.469-9(g)(3)
>
> Pursuant to IRC §469(c)(7)(A), Helen J. Smith, SSN 234-56-7890, qualifies as a real estate professional and elects to treat all rental real estate interests as one activity for 2004 and future years.

Question A. What should be done about the prior year's returns if losses were claimed and the practitioner realizes the client does not qualify for the loss deductions due to the lack of making the election in earlier tax years?

Answer A. An amended return should be filed.

Question B. If the practitioner was not aware of the Real Estate Professional Rule in earlier years, and the client has passive loss carryovers to 2004, will the election to aggregate all interests in real estate activities in 2004 allow the current year's deduction of the passive loss carryovers?

Answer B. No. The losses remain as passive loss carryovers, although they may be deducted under the $25,000 rental real estate exception, if the taxpayer qualifies for that exception.[50]

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49. Treas. Reg. §1.469-9(g)

50. Treas. Reg. §1.469-9(j)

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Question C. Is there a downside to making the election to aggregate all interests in real estate activities?

Answer C. Possibly. In order to deduct suspended losses on a disposition of part of an activity, the disposed part must constitute substantially all of the activity.[51] If a qualifying taxpayer properly elects to aggregate his interests in real estate activities in the first year he starts acquiring real estate properties, then no suspended passive loss carryovers will occur. In this case, there is no downside to making the election to aggregate. However, after the election to aggregate had been made, if the taxpayer has previous years' suspended losses, the suspended losses attributable to a specific real estate property may not be fully deductible in the year sold.

Question D. What about interests in S corporations or partnerships?

Answer D. A taxpayer's interest in rental real estate held by a partnership or an S corporation is treated as a single interest in rental real estate if the entity grouped its rental real estate as one rental activity. If not, each rental real estate activity of the entity is treated as a separate interest in real estate. However, the taxpayer may elect to treat all interest in rental real estate, including the rental real estate interests held by an S corporation or partnership, as a single rental real estate activity.[52]

If a taxpayer holds a 50% or greater interest in the capital, income, gain, loss, deduction, or credit in a partnership or S corporation for the taxable year, each interest in rental real estate held by the entity is treated as a separate interest in rental real estate, regardless of the entity's grouping of activities. However, the taxpayer may elect to treat all interests in rental real estate, including the taxpayer's share of the rental real estate interests held by the entities, as a single rental real estate activity.[53]

COURT DECISIONS

Caution. Some of the rulings discussed below are Tax Court Summary Opinions. These cannot be used as precedent for any other case.[54] However, reviewing these cases can be useful since they provide insight into the IRS's positions, taxpayer arguments, and the Tax Court's reasonings.

Lack of Proof for Time Spent on Real Estate Activities

Osama A. Mowafi v. Commr., **TC Memo 2001-111, 81 TCM 1605, May 10, 2001**

The Court ruled in favor of the IRS. The taxpayer failed to demonstrate that he was entitled to the real estate professional exception under IRC §469(c)(7). The taxpayer's testimony and noncontemporaneous time logs prepared in connection with the audit were insufficient to demonstrate that he qualified as a real estate professional. Consequently, the taxpayer failed to prove that during the two tax years at issue he performed more than half of his personal services in real property businesses in which he materially participated. He also failed to prove that he worked more than 750 hours a year in those real estate activities.

Note. This case is covered in detail in the *2001 University of Illinois Farm Income Tax Workbook* on pages 445–446.

51. IRC §469(g)
52. Treas. Reg. §1.469-9(h)(1)
53. Treas. Reg. §1.469-9(h)(2)
54. IRC §7463(b)

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Bruce and Judy Bailey v. Commr., **TC Memo 2001-296, 82 TCM 868, November 7, 2001**

A married couple's rental activities were found to be passive and their claimed deductions for rental losses were disallowed. The wife, an attorney, did not qualify as a real estate professional for one of the tax years at issue. Taxpayers had made the election under IRC §469 to aggregate their rental real estate interests. However, her unsubstantiated estimates of time spent on rental activities were not reasonable and did not reflect the hours that she devoted to the activities. Therefore, their activities relating to the properties were passive and the losses incurred were subject to passive loss limitations.

Note. This case is covered in detail in the *2002 University of Illinois Farm Income Tax Workbook* on pages 344–346.

Hajiyani v. Commr., **TC Summary Opinion 2001-183, December 12, 2001.**

The taxpayer owned 21 separate parcels of residential real property, either individually or in partnership with his spouse. Nevertheless, he did not qualify as a real estate professional according to the court. Aside from the taxpayer's vague testimony, the only evidence of the amount of personal services performed in 1994 related to his real estate rental property consisted of two calendars that did not describe the amount of time he spent either individually or in the aggregate on the rental properties. Therefore, the court concluded that his rental real estate activities were passive and subject to the maximum $25,000 loss deduction under §469(i).

William C. and Cheryl M. Fowler v. Commr., **TC Memo 2002-223, September 6, 2002**

Married owners of a closely-held C corporation that performed heating and air conditioning contracting services were not entitled to deduct losses incurred in their rental real estate activities. The husband did not qualify as a real estate professional because he failed to establish that he spent more than 750 hours in real property trades or business. Even if he had qualified, no election was made to aggregate the rental properties, and he did not meet the material participation requirements for any one of the properties.

Alfredo A. and Jane R. Galagar v. Commr., **TC Summary Opinion 2004-39, March 25, 2004.**

Married taxpayers were subject to the passive activity loss rules in connection with their investment real estate. The Tax Court rejected the husband's claim that he was a real estate professional under IRC §469(c)(7)(B) and, thus, not subject to the passive activity loss limitations. The taxpayer failed to document the number of hours he spent on his real estate activities. As such, the passive activity loss claimed by the taxpayers was limited to $25,000 minus the applicable phaseout amount.

Note. The *Galagar* case is also analyzed in the Passive Activities section of Chapter 13, Rulings and Cases, in this workbook.

Lack of Proof and/or Failure to Elect to Aggregate Interests

Jahina v. Commr., **TC Summary Opinion 2002-150, November 21, 2002**

The Jahinas owned eight rental properties. Mrs. Jahina managed the properties and worked 1800 hours annually as a controller for ColorGraphics, Inc. Mrs. Jahina kept a desk calendar to substantiate the time she spent managing the rental properties.The IRS challenged the validity of time she said she spent on the rental properties. The taxpayers had not made an election to treat their rental activities as one activity. Because she did not work **on any one** of the rental properties more than she worked on her wage jobs, and because she did not satisfy the 750-hour statutory minimum **for any one** of the rental properties, Mrs. Jahina did not meet the qualifications to be classified as a real estate professional.

Note. This case is covered in detail on pages 624–626 of the *2003 University of Illinois Federal Tax Workbook.*

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***Matti Kosonen v. Commr., TC Memo 2000-107*, 79 TCM 1765, March 28, 2000**

A real estate professional was not entitled to treat his seven real estate properties as a single activity for two tax years because he did not make proper elections to do so under §469. The aggregation of his losses on his tax returns and reporting his net losses as active did not substitute for making the election. Moreover, his failure to make the election was not excused by the absence of regulatory guidance for the first tax year at issue, and final regulations governing the election were adopted before his return for the second tax year was due. Since he did not substantially comply with the statutory requirements, the court decided the question of whether his failure to make the election resulted in unduly harsh consequences was irrelevant.

Note. This case is covered in detail on page 656 of the *2000 University of Illinois Farm Income Tax Workbook.*

ADDENDUM

The following excerpts are taken directly from the IRS MSSP guidelines. The purpose of the MSSP Guidelines is to provide the IRS examining agents in-depth training on specific audit issues.

Note. The date of issuance of this specific document was February 1996; the contents of this document are not new information.

Audit Techniques:

- *If Forms W-2 are from activities unrelated to a real property business, it is an indicator the taxpayer may not be able to meet the half personal services test.*
- *At the initial interview, inquire which spouse performs most of the work with the rental real estate and real property businesses.*
- *For the 750 hour test, verify that both spouses' time has not been combined. One spouse alone must meet both of the first two tests.*
- *Verify that the taxpayer is in a real property trade or business. An attorney or an accountant who specializes in real estate, for example, would not be a real property trade or business.*
- *For the third test, which requires material participation in the rental real estate activities, verify that the taxpayer materially participates in each separate rental real estate activity (unless an election has been filed to aggregate ALL rental activities as one). For this test, the husband's and wife's time may be combined. See the leadsheet in Exhibit 2-4 for the material participation tests as well as lesson 3 for an explanation of the rules.*
- *Also verify that the taxpayer has not added his or her time in real property businesses for the third test. The taxpayer must materially participate in each rental real estate activity without adding time from his or her real property businesses.*
- *If the taxpayer has filed an election to group his or her rental real estate as one activity, verify that he or she has grouped ALL rental real estate activities together. He or she cannot pick and choose only certain activities to group. Furthermore, verify that the taxpayer is not deducting suspended losses based on the sale of one of his or her properties (except to the extent of net gain from the disposition. The regulations indicate that any remaining suspended losses allocable to the disposed property are triggered only on disposition of substantially all of the activity.*
- *Verify that the taxpayer has not deducted suspended losses — unless he or she has (1) passive income from his or her rental real estate, (2) passive income from other activities or (3) an entire disposition (or substantially all) of the property. The taxpayer can, however, trigger up to $25,000 in suspended losses each*

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year if he or she continues to meet the active participation standard and his or her AGI is less than $100,000. Remember, however, that rental real estate losses allowable as a result of IRC section 469(c) (7) are an addback to modified AGI. Consequently, modified AGI is increased and the taxpayer may not qualify for the $25,000 offset.

- *A number of taxpayers have asked if the relief provisions can be applied retroactively to years prior to 1994. The answer is clearly no.*
- *Finally, the examiner should always verify that losses being deducted under IRC section 469(c) (7) are true rentals, and not a hotel or some other activity which falls outside the definition of a rental activity as defined in Treas. Reg. section 1.469-IT (e)(3).*

EXHIBIT 2-4: Relief Provisions for Real Estate Professionals Rental Real Estate and §469(c)(7)

Impacts: *Rental real estate activities*

Effective: *January 1, 1994 and subsequent years. Does not apply to 1993 and prior years.*

LAW: *Rental real estate losses are generally limited to $25,000 if taxpayer actively participates (making management decisions — IRC §469(i)).*

However, under new IRC §469(c)(7), if taxpayer spends most of his time in real property trades or businesses, meeting the one-half personal services and 750 hour tests, rental real estate losses are no longer per se passive. If he materially participates in each rental real estate activity, current year losses are fully deductible. If not, losses are deductible only up to $25,000 if active.

Carryover losses from prior years are not triggered by new IRC §469(c)(7). They should continue to be entered on Form 8582, line 1c until the taxpayer has income from the rental real estate, passive income from other activities or there is an entire disposition of the activity.

Carry-forward losses as result of IRC §469(c)(7) are treated as from a former passive activity.

*—Verify that taxpayer **or** spouse meets **both** of the following tests.*

At the initial interview, inquire which spouse performs most of the work with the real property businesses and/or the rental real estate activities. At least one spouse alone must satisfy the following two tests.

FIRST TEST:

*Are half of personal services in **all** trades or businesses (T/B) for the year performed in real property T/B?*

Forms W-2 attached to return and occupation will provide some indication as to whether taxpayer or spouse may meet this test. If Forms W-2 for both husband and wife are from activities unrelated to real property businesses, it is a strong indication that neither can qualify for the one-half personal services test.

—Real property T/B equals real property development, construction, acquisition, conversion, rental operation, management, leasing or brokerage.

—For time to be counted, taxpayer must materially participate in the real property T/B. Material participation is meeting any one of seven tests in Temp. Treas. Reg. §1.469-5T. The two most common are (1) does taxpayer spend 500 hours a year in the business, or (2) does he perform substantially all of the work?

NOTE. *For purposes of this test, each rental real estate activity is treated like a trade or business subject to material participation.*

—Time spent as an employee in real property activities in counted only if he is a more than 5% owner.

—In counting time for this test as well as the 750 hour test each spouse's personal services are taken into account separately. Thus one spouse must satisfy the requirement for half of his personal services in a real property T/B and the 750 hour test.

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SECOND TEST:

Does taxpayer spend more than 750 hours in real property T/B in which he materially participates?

*—If answer is **NO** to either of above two tests, new §469(c)(7) does not apply to taxpayer's rental real estate activities, and losses are limited to $25,000 plus passive income if taxpayer actively participates.*

*—If answer is **YES** to both tests, apply material participation tests to **each** rental real estate activity to determine whether each activity is passive or nonpassive. In other words, each rental real estate activity will be treated like a trade or business subject to material participation to determine whether losses are or are not deductible. The following are the seven material participation tests in Temp. Treas. Reg. §l.469-5T:*

—Does taxpayer and/or spouse spend more than 500 hours a year involved in the activity?

—Does taxpayer perform substantially all of the participation in the activity?

—Does taxpayer put in more than 100 hours and no one puts in more hours?

—Does taxpayer participate between 100-500 hours in each of several otherwise passive activities, and does the total participation exceed 500 hours?

—Did taxpayer materially participate in a personal service activity for any three prior taxable years?

*—Do facts and circumstances indicate taxpayer is materially participating? This test does not apply unless taxpayer worked more than 100 hours a year. Furthermore, it does not apply if any person received compensation for managing the activity **or** if any person spent more hours than the taxpayer managing the activity.*

NOTES:

Taxpayer may not group rental real estate with any business activity to meet material participation for purpose of this test. Furthermore, he must materially participate in each separate rental real estate activity unless he makes the election discussed below to group all his rental real estate interests into a single activity.

Each rental real estate interest must be treated as a separate activity - unless the taxpayer has elected to treat all his rental real estate interests as one activity by filing a statement with an original return. If all rental real estate activities are treated as one, it will be easier to meet the 500 hour material participation test. However, if taxpayer makes this election and subsequently disposes of a property, suspended losses will be triggered only up to the net gain on disposition.

CONCLUSION:

1. Per §469(c)(7), the following rental real estate activities have been determined to be nonpassive and current (but not carryover) losses are fully deductible:

—Enter current losses on Schedule E, but not on Form 8582.

2. Taxpayer did not materially participate in the following real estate activities, but does actively participate (making management decisions):

—Enter losses on Form 8582, line lb. NOTE: The $25,000 offset is not reduced by losses allowable under §469(c)(7).

3. Taxpayer does not actively participate in the following rental real estate activities:

—Enter losses on Form 8582, line 1c.

IMPORTANT. While this checksheet primarily addresses losses, under §469(c)(7), both income and losses could be recharacterized as nonpassive.

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