Chapter 1: Individual Taxpayer Problems

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

PROBLEM 1: ALTERNATIVE MINIMUM TAX UPDATE

BACKGROUND INFORMATION

Preliminary Statistics for the 2005 Tax Year.[1] The chart below compares the impact of AMT on individual tax returns for the 2004 and 2005 tax years.

Tax Year	Number of Returns Reporting AMT Liability	Amount of AMT Reported
2004	3.133 million	$12.06 billion
2005	4.045 million (29.1% increase)	15.87 billion (31.6% increase)

Of the total $15.87 billion of AMT reported on 2005 tax returns, 96% ($15.3 billion) was paid by taxpayers who reported 2005 AGIs of $100,000 or more. However, as the following chart demonstrates, the lowest income taxpayers subject to AMT — those with 2005 AGIs under $15,000 — reported the **highest average** AMT liability.

2005 AGI Range	Average Reported AMT Amount
Under $15,000	$16,920
$15,000 to $29,999	2,008
$30,000 to $49,999	1,523
$50,000 to $99,999	1,219
$100,000 to $199,999	1,807
$200,000 or more	5,724

Estimated Statistics for the 2006 Tax Year. Before the preliminary statistics for 2005 individual tax returns were released in March of 2007, the most highly regarded AMT research predicted that "3.5 million taxpayers will be affected by the AMT in 2006."[2]

However, since the preliminary IRS statistics for 2005 individual tax returns reported that 4 million taxpayers reported a 2005 AMT liability, the 3.5 million taxpayers estimate for 2006 tax returns may be low.

- If the rate of increase remained at 29.1% (see the first table above), a projected **5.2 million taxpayers would have reported an AMT liability on their 2006 returns.**
- If the rate of increase remained at 31.6% (see the first table above), it is projected that **individual taxpayers would have reported $20.9 billion of AMT for 2006.**

1. "Winter 2006–2007 Statistics of Income Bulletin," IRS News Release IR-2007-55 (March 12, 2007)
2. Greg Leiserson and Jeffrey Rohaly, "The Individual Alternative Minimum Tax: Historical Data and Projections," updated November 10, 2006, www.taxpolicycenter.org/publications/template.cfm?PubID=9923

2007 Anticipated AMT Exemption Amounts

As of the date this book was printed, Congress had taken no action regarding the 2007 AMT exemption amounts. Based on the best information available, it is likely that legislation will be enacted to keep the 2007 AMT exemption amounts at 2006 levels. Therefore, the balance of Problem 1, AMT Update, uses that assumption. If the 2007 AMT exemption amounts differ from those allowed for 2006, see the "2008 What's New Supplement" on the University of Illinois Tax School website (**www.ace.uiuc.edu/TaxSchool**) for revisions to Problem 1. This supplement will be available in January 2008.

The anticipated 2007 exemption and phaseout amounts are below. AMTI is alternative minimum taxable income, shown on line 28, Form 6251.

Anticipated 2007 AMT Exemption Amounts

Tax Year	Married Filing Jointly and Surviving Spouse	Single and Head of Household	Married Filing Separately
2007 (assumed)	$62,550	$42,500	$31,275

Note. The minimum 2007 AMT exemption amount for a child under age 18 increased to $6,300. The child may increase this AMT exemption by the amount of his earned income. See the Exemption Worksheet for line 29 in the 2007 Instructions for Form 6251 for more information.

Anticipated 2007 AMT Exemption AMTI Phaseout Ranges

Tax Year	Married Filing Jointly and Surviving Spouse	Single and Head of Household	Married Filing Separately
2007 (assumed)	$150,000–400,200	$112,500–282,500	$75,000–200,100

It is expected that the anticipated 2007 legislation will extend current law by allowing most personal tax credits to be claimed against both regular tax and AMT liability. **If so, individual taxpayers will continue to receive the full benefit of the following 2007 personal tax credits:**

- Child and dependent care credit (Form 2441)
- Credit for the elderly or the disabled (Schedule R)
- Child tax credit (Form 8901, if required)
- Education credits (Form 8863)
- Adoption credit (Form 8839)
- Retirement savings contribution credit (Form 8880)
- Mortgage interest credit (Form 8396)
- Residential energy tax credit (Form 5695)

Note. The tax credit for new qualified hybrid vehicles was not allowed against 2006 AMT liability. Therefore, individual taxpayers impacted by AMT on their 2006 tax returns were denied part or all of their otherwise allowable hybrid vehicle tax credit. As of the date this book was printed, Congress had taken no action regarding an extension of the 2006 AMT rules to 2007 tax returns.

National Taxpayer Advocate Report.[3] Nina Olson, the National Taxpayer Advocate, released her 2006 report to Congress in January 2007. In it, she designated the AMT for individuals and the federal tax gap as the most serious problems facing taxpayers. The executive summary of the AMT issue is shown below.

> *The National Taxpayer Advocate believes that the most serious problem facing taxpayers today is the complexity of the Internal Revenue Code, and the poster child for tax-law complexity is the Alternative Minimum Tax for individuals (AMT). . . . While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed. Today, the AMT is left to punish taxpayers for engaging in such "classic tax-avoidance behavior" as having children or living in a high-tax state.*
>
> *To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many, if not most, taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their government has dealt fairly with them. To say the least, "gotcha" taxation is not good for taxpayers or the tax system. The National Taxpayer Advocate recommends that Congress repeal the provisions of the Internal Revenue Code that pertain to the Alternative Minimum Tax for individuals.*

NEW MINIMUM TAX CREDIT RULES FOR 2007 RETURNS

> **Note.** The **new rules** for 2007 returns apply to AMT credits carried forward from 2003 or earlier. The background information provided here is used later in the chapter to illustrate how the new rules apply to 2007 returns.

Background Information. One of the most costly inequities of AMT law prior to 2007 occurred when:

1. The taxpayer exercised an incentive stock option (ISO) and did not sell the stock in the year the ISO was exercised.
2. The shares acquired via the ISO exercise either lost value or became worthless in a later year.
3. The taxpayer paid significant AMT in the year of exercise on the "phantom income" AMT adjustment.
4. The taxpayer had to borrow money to pay the AMT liability in the year of the ISO exercise.

This unfortunate situation is explained in the following example.

Example 1. Jane exercised her employer's ISO in March 2003. **This was not a cashless exercise.** Jane used her own funds for the $10,000 grant price that she paid for the stock. **She did not sell the stock acquired by the ISO exercise in 2003 because she expected the stock to appreciate.** Following are the details relating to her 2003 exercise of the ISO:

Number of Titan Co. shares purchased	10,000
Exercise grant price per share (purchase price)	$ 1
Market value price per share at the time of exercise	60
Untaxed (for regular tax) "bargain element" per share ($60–$1 purchase price)	59
Untaxed (for regular tax) total "bargain element" gain (10,000 shares × $59)	590,000

Jane reported $590,000 as an AMT adjustment on line 13 of her 2003 Form 6251. Her 2003 AMT was $171,525. Jane's 2003 Form 6251 is shown below. The $590,000 AMT adjustment on line 13 is "phantom income," not real income that can be spent. Jane was forced to borrow funds to pay her 2003 AMT liability of $171,525.

3. IRS News Release IR-2007-04 (January 9, 2007)

For Example 1

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

Alternative Minimum Tax— Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

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

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

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

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 38, and go to line 2. Otherwise, enter the amount from Form 1040, line 35, and go to line 7. (If zero or less, enter as a negative amount.)	1	100,000
2	Medical and dental. Enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2½% of Form 1040, line 35	2	
3	Taxes from Schedule A (Form 1040), line 9	3	14,000
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	
5	Miscellaneous deductions from Schedule A (Form 1040), line 26	5	
6	If Form 1040, line 35, is over $139,500 (over $69,750 if married filing separately), enter the amount from line 9 of the worksheet for Schedule A (Form 1040), line 28	6	( )
7	Tax refund from Form 1040, line 10 or line 21	7	(700)
8	Investment interest expense (difference between regular tax and AMT)	8	
9	Depletion (difference between regular tax and AMT)	9	
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10	
11	Interest from specified private activity bonds exempt from the regular tax	11	
12	Qualified small business stock (see instructions)	12	
13	Exercise of incentive stock options (excess of AMT income over regular tax income)	13	590,000
14	Estates and trusts (amount from Schedule K-1 (Form 1041), line 9)	14	
15	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15	
16	Disposition of property (difference between AMT and regular tax gain or loss)	16	
17	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	17	
18	Passive activities (difference between AMT and regular tax income or loss)	18	
19	Loss limitations (difference between AMT and regular tax income or loss)	19	
20	Circulation costs (difference between regular tax and AMT)	20	
21	Long-term contracts (difference between AMT and regular tax income)	21	
22	Mining costs (difference between regular tax and AMT)	22	
23	Research and experimental costs (difference between regular tax and AMT)	23	
24	Income from certain installment sales before January 1, 1987	24	( )
25	Intangible drilling costs preference	25	
26	Other adjustments, including income-based related adjustments	26	
27	Alternative tax net operating loss deduction	27	( )
28	**Alternative minimum taxable income.** Combine lines 1 through 27. (If married filing separately and line 28 is more than $191,000, see page 7 of the instructions.)	28	703,300

Part II **Alternative Minimum Tax**

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

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

If line 28 is **over** the amount shown above for your filing status, see page 7 of the instructions. — **29** — 0

30	Subtract line 29 from line 28. If zero or less, enter -0- here and on lines 33 and 35 and stop here	30	703,300
31	• If you reported capital gain distributions directly on Form 1040, line 13a; you reported qualified dividends on Form 1040, line 9b; **or** you had a gain on both lines 16 and 17a of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 65 here. • **All others:** If line 30 is $175,000 or less ($87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result.	31	193,424
32	Alternative minimum tax foreign tax credit (see page 7 of the instructions)	32	
33	Tentative minimum tax. Subtract line 32 from line 31	33	193,424
34	Tax from Form 1040, line 41 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 44)	34	21,899
35	**Alternative minimum tax.** Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 42	35	171,525

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

Observations for Jane's 2003 Form 6251

- Jane is not entitled to an AMT exemption on line 29 because it was completely phased out due to her high AMTI on line 28.
- Jane's 2003 taxable income of $96,950 resulted in a regular tax of $21,899 (from the Tax Table). This amount is reported on line 34.
- Because Jane's 2003 AMT was caused by a **deferral item** — phantom income from the exercise of an ISO — she may be entitled to a minimum tax credit on Form 8801 for 2004 and later tax years.

Additional Facts for 2007

1. The value of Jane's 10,000 shares purchased in 2003 via her ISO was only $5 a share when she sold them in May 2007.
2. Jane's sales price for the 10,000 shares produced only $50,000 in 2007 (10,000 shares × $5), far less than the $171,525 of AMT she had to borrow to pay her 2003 taxes.
3. Jane's cost basis in the 10,000 shares she sold in 2007 is $10,000 for regular tax purposes, the amount she paid to acquire the stock in 2003. Her long-term gain in 2007 is $40,000 for regular tax purposes.

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

Capital Gains and Losses
▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2007
Attachment Sequence No. 12

Name(s) shown on return: Jane
Your social security number: 111 11 1111

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 10,000 shares Titan Co	03/10/03	05/23/07	50,000	10,000	40,000

9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . 9

10 **Total long-term sales price amounts.** Add lines 8 and 9 in column (d) . . . 10 50,000

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . 11

12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . 12

13 Capital gain distributions. See page D-2 of the instructions . . . 13

14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . . 14 ( )

15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back . . . 15 40,000

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2007**

4. Jane's cost basis in the 10,000 shares she sold in 2007 is $600,000 for AMT purposes. It consists of two elements:
   - $10,000 basis for regular tax, plus
   - $590,000 AMT adjustment reported on line 13 on her 2003 Form 6251.

Change the paragraph before the form for Example 1 to read: "Jane has a 2007 AMT loss of $550,000 on the sale of the 10,000 shares. However, the AMT loss is limited to $3,000. The difference between the regular tax gain of $40,000 and the allowable AMT loss of $3,000 is $43,000. This is entered as a negative figure on line 16 of her Form 6251. Therefore, it is unlikely that Jane will have a 2007 AMT liability.

For Example 1

Form **6251** — **Alternative Minimum Tax—Individuals** — OMB No. 1545-0074 — **2007**

Department of the Treasury Internal Revenue Service (99) — ▶ See separate instructions. ▶ Attach to Form 1040 or Form 1040NR. — Attachment Sequence No. **32**

Name(s) shown on Form 1040 or Form 1040NR: **Jane** — Your social security number: **111 11 1111**

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

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41, and go to line 2. Otherwise, enter the amount from Form 1040, line 38, and go to line 7. (If less than zero, enter as a negative amount.)	1		
2	Medical and dental. Enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2½% of Form 1040, line 38. If zero or less, enter -0-	2		
3	Taxes from Schedule A (Form 1040), line 9	3		
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions	4		
5	Miscellaneous deductions from Schedule A (Form 1040), line 27	5		
6	If Form 1040, line 38, is over $156,400 (over $78,200 if married filing separately), enter the amount from line 11 of the **Itemized Deductions Worksheet** on page A-7 of the instructions for Schedule A (Form 1040)	6	(	)
7	Tax refund from Form 1040, line 10 or line 21	7	(	)
8	Investment interest expense (difference between regular tax and AMT)	8		
9	Depletion (difference between regular tax and AMT)	9		
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10		
11	Interest from specified private activity bonds exempt from the regular tax	11		
12	Qualified small business stock (7% of gain excluded under section 1202)	12		
13	Exercise of incentive stock options (excess of AMT income over regular tax income)	13		
14	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	14		
15	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15		
16	Disposition of property (difference between AMT and regular tax gain or loss)	16	**(43,000)**	
17	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	17		
18	Passive activities (difference between AMT and regular tax income or loss)	18		
19	Loss limitations (difference between AMT and regular tax income or loss)	19		
20	Circulation costs (difference between regular tax and AMT)	20		
21	Long-term contracts (difference between AMT and regular tax income)	21		
22	Mining costs (difference between regular tax and AMT)	22		
23	Research and experimental costs (difference between regular tax and AMT)	23		
24	Income from certain installment sales before January 1, 1987	24	(	)
25	Intangible drilling costs preference	25		
26	Other adjustments, including income-based related adjustments	26		
27	Alternative tax net operating loss deduction	27	(	)

Note. See page 469 in the 2005 *University of Illinois Federal Tax Workbook* for a thorough analysis of the *Speltz* Tax Court case[4] which involved a similar factual situation as explained in this example.

4. *Ronald J. and June M. Speltz v. Comm'r*, 124 TC 165 (2005)

Change in Law to the Minimum Tax Credit Made by the Tax Relief and Health Care Act of 2006 (TRHCA).[5] The inequity demonstrated by **Example 1** was partially relieved by a provision of TRHCA which the president signed on December 20, 2006. This legislation was sponsored by two representatives, one Republican and one Democrat. Following is a quote from one of the representatives regarding the change in tax law.[6]

> *[This legislation is] necessary because those taxpayers affected have effectively given the U.S. Government a $1.7 billion interest-free loan. "The time has finally come for the federal government to rebate these interest-free loans from working families," Johnson said. "The phantom gains were money my constituents never saw, never spent, and yet they had to pay taxes on. That's a crying shame."*

Explanation of the New Law. The framework for this favorable law change is complex and contains phaseouts for high-income taxpayers. The revised 2007 Form 8801, *Credit for Prior Year Minimum Tax — Individuals,* is a three page form. Part IV on page 3 calculates the "tentative refundable credit" amount.

> **Note. Example 2,** shown later, includes a completed 2007 Form 8801.

Basic Explanation. The new law, effective for 2007 individual returns, provides the following:

1. **"Long-term unused minimum tax credits"** are refundable beginning with 2007 Forms 1040.
2. A **"long-term unused minimum tax credit"** is one which relates to **AMT paid for a tax year at least four years prior to the current year** which has been carried forward to the current year. For 2007, the long-term unused minimum tax credit is the amount of minimum tax credit carryforward from 2003, reduced by the amount of any minimum tax credits claimed for 2004, 2005, and 2006 (line 25 of the 2004, 2005, and 2006 Forms 8801).[7]
3. The amount of the **refundable**[8] AMT credit amount in tax years 2007 through 2012 is limited to the **greater of**:
   a. 20% of the taxpayer's "long-term unused minimum tax credit", or
   b. The **lesser of** $5,000 or the amount of the taxpayer's "long-term unused minimum tax credit."[9]

   To illustrate this calculation:

   - Scott has an unused AMT credit carryforward to 2007 of $300 from 2003.

20% of $300	$ 60
The lesser of $5,000 or $300	300
The greater of $60 or $300	300

   - Cari has an unused AMT credit carryforward to 2007 of $5,400 from 2003.

20% of $5,400	$1,080
The lesser of $5,000 or $5,400	5,000
The greater of $1,080 or $5,000	5,000

5. IRC §53(e), as amended by the Tax Relief and Health Care Act (TRHCA) of 2006
6. Ryan J. Donmoyer, "Workers Whose Stock Options Left Them in Debt to Get a Break," Bloomberg.com, December 12, 2006, www.bloomberg.com/apps/news?pid=newsarchive&sid=aDkgixijU9dQ
7. "Tax Law Changes for Individuals," www.irs.gov/formspubs/article/0,,id=109876,00.html
8. IRC §53(e)(4)
9. IRC §53(e)(2)(A)

4. The refundable AMT credit is **phased out** for high-income taxpayers. The phaseout rules apply the same AGI threshold amounts as used for the phaseout of personal exemptions.

   For every $2,500 ($1,250 if the filing status is married filing separately) that AGI exceeds the threshold amount, the refundable credit is reduced by 2%.

   For **2007,** the refundable AMT credit is **reduced** if AGI is more that the applicable amount in the second column of the following table. The credit is **eliminated** if AGI is more than the applicable amount in the third column.[10]

Filing Status	AGI That Reduces Credit	AGI That Eliminates Credit
Single	$156,400	$278,900
Married filing jointly or qualifying widow(er)	234,600	357,100
Married filing separately	117,300	178,550
Head of household	195,500	318,000

Observations. This provision of TRHCA does not represent a total fix for the inequity described in **Example 1.** Essentially, unless the phaseout rules apply, taxpayers will be entitled to a refundable credit of their "long-term unused minimum tax credit" beginning in 2007 and ending in 2012.

However, many taxpayers in situations like **Example 1** have not yet paid the IRS the enormous AMT amounts that were due in **2003 or earlier years** when the ISO was exercised. The new law does not apply to these taxpayers. The new provision benefits only those taxpayers who actually fully paid the AMT in 2003 or an earlier year.

High-income taxpayers who paid the AMT in the prior year and who are subject to the complete phaseout of the refundable credit are facing this decision: Do they continue to work and therefore forgo a potentially large nontaxable refund? Or do they quit work or work part-time during 2007 through 2012 and thereby qualify for the refund?

Although this new tax provision will affect relatively few taxpayers, it will have very positive results for those who can qualify for this new refundable credit.

Effective Date of This Provision. This provision of TRHCA applies to tax years that begin after December 20, 2006. The provision sunsets after 2012. As a result, this refundable credit will be available for 2007 through 2012 individual tax returns.

Note. For calendar-year individuals, these new rules will first be effective for 2007 Forms 1040.

10. "Tax Law Changes for Individuals," www.irs.gov/formspubs/article/0,,id=109876,00.html

Example 2. In **Example 1,** Jane's total 2003 tax liability was $193,424. It consisted of:

Regular tax	$ 21,899
AMT	171,525
Total 2003 tax	**$193,424**

Jane borrowed money to pay the IRS the full amount due on her 2003 return. In 2004, 2005, and 2006, Jane reported the following:

Year	Regular Tax	Tentative Minimum Tax (Form 6251)	Minimum Tax Credit (Form 8801)
2004	$5,000	$0	$ 5,000
2005	5,000	0	5,000
2006	5,000	0	5,000
Total minimum tax credits used for 2004, 2005 and 2006			**$15,000**

Jane's **"long-term unused minimum tax credit"** which she carries forward to 2007 is **$156,525** ($171,525 AMT paid in 2003 less $15,000 minimum tax credits used on her 2004, 2005 and 2006 returns).

In 2007, Jane's gross income consists of wages and long-term capital gain (for regular tax purposes) on the sale of all the shares of Titan Co. stock which she acquired in 2003 via the exercise of her incentive stock option. Her 2007 AGI and taxable income computations follow:

Wages	$ 65,000
Long-term capital gain (for regular tax) on sale of ISO stock acquired in 2003	40,000
2007 AGI	**$105,000**
Less: itemized deductions	(9,200)
Less: exemption	(3,400)
2007 taxable income	**$ 92,400**
2007 regular tax from qualified dividends and capital gain tax worksheet	**$ 15,530**

Jane is single and has no tentative minimum tax on her 2007 Form 6251. The only credits on her 2007 Form 1040 is the minimum tax credit from Form 8801 (shown on page 11). Since her 2007 AGI of $105,000 is less than $156,400, she is not subject to the phaseout of the refundable AMT credit.

Tax Result for Example 2. The amount of Jane's 2007 tentative refundable AMT credit is $31,305, or 20% of $156,525.

> **Note.** The tentative refundable AMT credit of $31,305 is reported on lines 54 and 26 on Jane's 2007 Form 8801. The tentative credit is reduced by $15,530, the amount by which her 2007 regular tax of $15,530 exceeds her 2007 tentative minimum tax of zero. Therefore, Jane's 2007 refundable AMT credit is $15,775 ($31,305 less $15,530, the amount of the nonrefundable minimum tax credit).

The following forms are shown for Jane:

- 2004 Form 8801
- 2007 Form 8801 (pages 1 and 3 only. Part 1 is partially completed.)
- 2007 Form 1040 (pages 1 and 2)

For Example 2

Form **8801** Department of the Treasury Internal Revenue Service (99)

Credit for Prior Year Minimum Tax— Individuals, Estates, and Trusts

▶ See instructions on pages 3 and 4.
▶ Attach to Form 1040, 1040NR, or 1041.

OMB No. 1545-1073 **2004** Attachment Sequence No. **74**

Name(s) shown on return: **Jane** | Identifying number: **111-11-1111**

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 1, 6, and 10 of your 2003 Form 6251. Estates and trusts, see instructions	1	100,000
2	Enter adjustments and preferences treated as exclusion items (see instructions) $\boxed{14{,}000 - 700}$	2	13,300
3	Minimum tax credit net operating loss deduction (see instructions)	3	( )
4	Combine lines 1, 2, and 3. If zero or less, enter -0- here and on line 15 and go to Part II. If more than $191,000 and you were married filing separately for 2003, see instructions	4	113,300
5	Enter: $58,000 if married filing jointly or qualifying widow(er) for 2003; $40,250 if single or head of household for 2003; or $29,000 if married filing separately for 2003. Estates and trusts, enter $22,500	5	40,250
6	Enter: $150,000 if married filing jointly or qualifying widow(er) for 2003; $112,500 if single or head of household for 2003; or $75,000 if married filing separately for 2003. Estates and trusts, enter $75,000	6	112,500
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	800
8	Multiply line 7 by 25% (.25)	8	200
9	Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 14, see instructions	9	40,050
10	Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15 and go to Part II. Form 1040NR filers, see instructions	10	73,250
11	• If **for 2003** you reported capital gain distributions directly on Form 1040, line 13a; you reported qualified dividends on Form 1040, line 9b (Form 1041, line 2b(2)); **or** you had a gain on both lines 16 and 17a of Schedule D (Form 1040) (lines 15a and 16a, column (2), of Schedule D (Form 1041)), complete Part III of Form 8801 and enter the amount from line 58 here. • **All others:** If line 10 is $175,000 or less ($87,500 or less if married filing separately for 2003), $\boxed{\text{multiply line 10 by 26\% (.26).}}$ Otherwise, multiply line 10 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately for 2003) from the result.	11	19,045
12	Minimum tax foreign tax credit on exclusion items (see instructions)	12	0
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	19,045
14	Enter the amount from your 2003 Form 6251, line 34, or 2003 Form 1041, Schedule I, line 55	14	21,899
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	0

Part II Minimum Tax Credit and Carryforward to 2005

16	Enter the amount from your 2003 Form 6251, line 35, or 2003 Form 1041, Schedule I, line 56	16	171,525
17	Enter the amount from line 15 above	17	0
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	171,525
19	**2003 minimum tax credit carryforward.** Enter the amount from your 2003 Form 8801, line 26	19	0
20	Enter the total of your 2003 unallowed nonconventional source fuel credit and 2003 unallowed qualified electric vehicle credit (see instructions)	20	0
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	171,525
22	Enter your 2004 regular income tax liability minus allowable credits (see instructions)	22	5,000
23	Enter the amount from your 2004 Form 6251, line 33, or 2004 Form 1041, Schedule I, line 54	23	0
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	5,000
25	**Minimum tax credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on your 2004 Form 1040, line 54; Form 1040NR, line 49; or Form 1041, Schedule G, line 2d	25	5,000
26	**Minimum tax credit carryforward to 2005.** Subtract line 25 from line 21. Keep a record of this amount because you may use it in future years	26	166,525

For Paperwork Reduction Act Notice, see page 4. Cat. No. 10002S Form **8801** (2004)

For Example 2

Form **8801**
Department of the Treasury Internal Revenue Service (99)

Credit for Prior Year Minimum Tax— Individuals, Estates, and Trusts

► See separate instructions.
► Attach to Form 1040, 1040NR, or 1041.

OMB No. 1545-1073
2007
Attachment Sequence No. **74**

Name(s) shown on return: **Jane**
Identifying number: **111-11-1111**

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 1, 6, and 10 of your 2006 Form 6251. Estates and trusts, see instructions	1	
2	Enter adjustments and preferences treated as exclusion items (see instructions)	2	
3	Minimum tax credit net operating loss deduction (see instructions)	3	( )
4	Combine lines 1, 2, and 3. If more than zero **or** you filed Form 2555 or 2555-EZ for 2006, go to line 5. If zero or less and you did not file Form 2555 or 2555-EZ for 2006, enter -0- here and on line 15 and go to Part II. If more than $200,100 and you were married filing separately for 2006, see instructions	4	
5	Enter: $62,550 if married filing jointly or qualifying widow(er) for 2006; $42,500 if single or head of household for 2006; or $31,275 if married filing separately for 2006. Estates and trusts, enter $22,500	5	
6	Enter: $150,000 if married filing jointly or qualifying widow(er) for 2006; $112,500 if single or head of household for 2006; or $75,000 if married filing separately for 2006. Estates and trusts, enter $75,000	6	
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	
8	Multiply line 7 by 25% (.25)	8	
9	Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 18, see instructions	9	
10	Subtract line 9 from line 4. If more than zero **or** you filed Form 2555 or 2555-EZ for 2006, go to line 11. If zero or less and you did not file Form 2555 or 2555-EZ for 2006, enter -0- here and on line 15 and go to Part II. Form 1040NR filers, see instructions	10	
11	• If **for 2006** you filed Form 2555 or 2555-EZ, see page 2 of the instructions for the amount to enter. • If **for 2006** you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b (Form 1041, line 2b(2)); **or** you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (lines 14a and 15, column (2), of Schedule D (Form 1041)), complete Part III of Form 8801 and enter the amount from line 48 here. • **All others:** If line 10 is $175,000 or less ($87,500 or less if married filing separately for 2006), multiply line 10 by 26% (.26). Otherwise, multiply line 10 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately for 2006) from the result.	11	
12	Minimum tax foreign tax credit on exclusion items (see instructions)	12	
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	
14	Enter the amount from your 2006 Form 6251, line 34, or 2006 Form 1041, Schedule I, line 55	14	
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	0

Part II Current Year Nonrefundable and Refundable Credits and Carryforward to 2008

16	Enter the amount from your 2006 Form 6251, line 35, or 2006 Form 1041, Schedule I, line 56	16	0
17	Enter the amount from line 15 above	17	0
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	0
19	**2006 minimum tax credit carryforward.** Enter the amount from your 2006 Form 8801, line 26	19	156,525
20	Enter your 2006 unallowed qualified electric vehicle credit (see instructions)	20	0
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	156,525
22	Enter your 2007 regular income tax liability minus allowable credits (see instructions)	22	15,530
23	Enter the amount from your 2007 Form 6251, line 33, or 2007 Form 1041, Schedule I, line 54	23	0
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	15,530
25	**Current year nonrefundable credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on your 2007 Form 1040, line 55; Form 1040NR, line 50; or Form 1041, Schedule G, line 2d	25	15,530
26	• **Estates and trusts:** Leave lines 26 and 27 blank and go to line 28. • **Individuals:** Did you have a minimum tax credit carryforward to 2005 (on your 2004 Form 8801, line 26)? ☐ **No.** Leave lines 26 and 27 blank and go to line 28. ☒ **Yes.** Complete Part IV of Form 8801 to figure the amount to enter	26	31,305
27	Is line 26 more than line 25? ☐ **No.** Leave line 27 blank and go to line 28. ☒ **Yes.** Subtract line 25 from line 26. This is your **current year refundable credit.** Enter the result here and on your 2007 Form 1040, line 71, or Form 1040NR, line 69	27	15,775
28	**Credit carryforward to 2008.** Subtract the larger of line 25 or line 26 from line 21. Keep a record of this amount because you may use it in future years	28	125,220

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 10002S Form **8801** (2007)

For Example 2

Form 8801 (2007) **Jane 111-11-1111** Page **3**

Part IV **Tentative Refundable Credit**

49 Enter the amount from line 26 of your 2004 Form 8801			49	166,525
50 Enter the amount from line 25 of your 2005 Form 8801	50	5,000		
51 Enter the amount from line 25 of your 2006 Form 8801	51	5,000		
52 Add lines 50 and 51			52	10,000
53 Subtract line 52 from line 49 (If zero or less, **stop;** enter -0- on line 26. **Do not** complete the rest of Part IV)			53	156,525
54 If line 53 is: ● Less than $5,000, enter the amount from line 53 ● At least $5,000, but not more than $25,000, enter $5,000 ● More than $25,000, multiply line 53 by 20% (.20)			54	31,305
55 Enter the amount from Form 1040, line 38, or Form 1040NR, line 36 (If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from sources within Puerto Rico, see instructions for the amount to enter)	55	105,000		
56 Is line 55 more than the amount shown below for your filing status? ● Single—$156,400 ● Married filing jointly or qualifying widow(er)—$234,600 ● Married filing separately—$117,300 ● Head of Household—$195,500 ☒ **No. Stop;** enter the amount from line 54 above on line 26. **Do not** complete the rest of Part IV. ☐ **Yes.** Enter the amount shown above for your filing status	56			
57 Subtract line 56 from line 55	57			
58 Is line 57 more than $122,500 ($61,250 if married filing separately)? ☐ **Yes. Stop;** enter -0- on line 26. **Do not** complete the rest of Part IV. ☐ **No.** Divide line 57 by $2,500 ($1,250 if married filing separately). If the result is not a whole number, increase it to the next higher whole number (for example, increase 0.0004 to 1)	58			
59 Multiply line 58 by 2% (.02) and enter the result as a decimal (rounded to at least three places)			59	.
60 Multiply line 54 by line 59			60	
61 Subtract line 60 from line 54. Enter the result here and on line 26			61	

Form **8801** (2007)

For Example 2

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2007 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type. LABEL HERE	Your first name and initial: Jane	Last name		**Your social security number** 111 11 1111
	If a joint return, spouse's first name and initial	Last name		**Spouse's social security number**
	Home address (number and street). If you have a P.O. box, see page 16.		Apt. no.	You **must** enter your SSN(s) above.
	City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.			Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ **You** ☐ **Spouse**

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 19)
			☐
			☐
			☐
			☐

If more than four dependents, see page 19.

d Total number of exemptions claimed

Boxes checked on 6a and 6b
No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see page 20)
Dependents on 6c not entered above
Add numbers on lines above ▶ **1**

Income

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

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	65,000
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends (see page 23)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 24)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	40,000
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount (see page 25)	15b	
16a	Pensions and annuities 16a	b Taxable amount (see page 26)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	105,000

Adjusted Gross Income

23	Educator expenses (see page XX)	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	Health savings account deduction. Attach Form 8889	25		
26	Moving expenses. Attach Form 3903	26		
27	One-half of self-employment tax. Attach Schedule SE	27		
28	Self-employed SEP, SIMPLE, and qualified plans	28		
29	Self-employed health insurance deduction (see page 29)	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid b Recipient's SSN ▶	31a		
32	IRA deduction (see page 31)	32		
33	Student loan interest deduction (see page 33)	33		
34	Tuition and fees deduction. Attach Form 8917	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 31a and 32 through 35		36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	105,000

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 80. Cat. No. 11320B Form **1040** (2007)

For Example 2

Form 1040 (2007) **Jane 111-11-1111** Page **2**

Tax and Credits

38	Amount from line 37 (adjusted gross income)			38	105,000
39a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. **Total boxes checked** ▶ **39a** ☐				
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶ 39b ☐				
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40	9,200
41	Subtract line 40 from line 38			41	95,800
42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX			42	3,400
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	92,400
44	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889			44	15,530
45	**Alternative minimum tax** (see page 39). Attach Form 6251			45	0
46	Add lines 44 and 45 ▶			46	15,530
47	Credit for child and dependent care expenses. Attach Form 2441	47			
48	Credit for the elderly or the disabled. Attach Schedule R	48			
49	Education credits. Attach Form 8863	49			
50	Residential energy credits. Attach Form 5695	50			
51	Foreign tax credit. Attach Form 1116 if required	51			
52	Child tax credit (see page XX). Attach Form 8901 if required	52			
53	Retirement savings contributions credit. Attach Form 8880	53			
54	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839	54			
55	Other credits: **a** ☐ Form 3800 **b** ☒ Form 8801 **c** ☐ Form____	55	15,530		
56	Add lines 47 through 55. These are your **total credits**			56	15,530
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶			57	0

Standard Deduction for—
- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

Other Taxes

58	Self-employment tax. Attach Schedule SE	58	
59	Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919	59	
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60	
61	Advance earned income credit payments from Form(s) W-2, box 9	61	
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57 through 62. This is your **total tax** ▶	63	0

Payments

64	Federal income tax withheld from Forms W-2 and 1099	64	10,000		
65	2007 estimated tax payments and amount applied from 2006 return	65			
66a	**Earned income credit (EIC)**	66a			
b	Nontaxable combat pay election ▶ 66b				
67	Excess social security and tier 1 RRTA tax withheld (see page 60)	67			
68	Additional child tax credit. Attach Form 8812	68			
69	Amount paid with request for extension to file (see page 60)	69			
70	Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	70			
71	Refundable credit for prior year minimum tax from Form 8801, line 27	71	15,775		
72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶			72	25,775

If you have a qualifying child, attach Schedule EIC.

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid**			73	25,775
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐			74a	25,775
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings				
▶ d	Account number				
75	Amount of line 73 you want **applied to your 2008 estimated tax** ▶	75			

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 62 ▶			76	
77	Estimated tax penalty (see page 62)	77			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? ☐ **Yes.** Complete the following. ☐ **No**

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

Sign Here

Joint return? See page 17. Keep a copy for your records.

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

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

Paid Preparer's Use Only

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

Form **1040** (2007)

Printed on recycled paper

Observations for Example 2

1. Jane benefits from the new law because her $156,525 minimum tax credit carryforward to 2007 was generated by her payment of $171,525 of AMT in **2003**.

2. Jane's remaining minimum tax credit of $125,220 is carried forward to 2008. This carryforward is shown on line 28 of her Form 8801 (page 11).

Note. According to recent guidance provided by the National IRS Office, the calculation of Jane's minimum tax credits for 2008 through 2012 will be made on a **20% declining balance method.** Using this method, the "long-term unused minimum tax credit" will be reduced by the AMT credit allowed in 2007 before calculating the 20% allowable AMT credit for 2008.

Based on the current IRS interpretation, Jane will not be entitled to a $31,305 AMT credit (refundable or nonrefundable) on her 2008, 2009, 2010 and 2011 tax returns. **The $31,305 amount is 20% of the $156,525 "long-term unused minimum tax credit" which she carried forward to 2007 (see page 9).**

Whether the current IRS interpretation represents Congressional intent remains unclear.

3. If Jane had exercised her ISO in **2004** rather than in 2003 and had paid $171,525 AMT on her **2004** tax return due to the exercise, she would **not** benefit from the new refundable credit provision on her 2007 tax return. Her payment of 2004 AMT would not become a "long-term unused minimum tax credit" until 2008.

   However, with this change in facts, Jane could still qualify for a minimum tax credit on her 2007 return by applying the rules in existence before the law change was made. To accomplish this, Jane completes a 2007 Form 8801. Any minimum tax credit computed using this change in facts would **not** be refundable.

Note. See pages 59–63 in the 2006 *University of Illinois Federal Tax Workbook* for more information on the credit for prior-year minimum tax on Form 8801.

PROBLEM 2: HEALTH SAVINGS ACCOUNT UPDATE

BACKGROUND INFORMATION

Preliminary Statistics for the 2005 Tax Year.[11] The chart below compares the impact of health savings accounts (HSAs) on individual tax returns for the 2004 and 2005 tax years.

Tax Year	No. of Returns Reporting HSA Deductions	Amount of HSA Deductions
2004	88,110	$180.2 million
2005	211,766 (140.3% increase)	488.8 million (171.3% increase)

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11. "Winter 2006–2007 Statistics of Income Bulletin," IRS News Release IR-2007-55 (March 12, 2007)

12. Ann Carrns, "Banks Pile into Health Savings Accounts," *The Wall Street Journal*, November 14, 2006

Estimated Statistics for 2006 Tax Year. It is estimated that 3.6 million HSA accounts were established as of the end of 2006.[12] This figure includes separate HSAs owned by spouses.

Observation. The driving force behind the rising tide of HSAs is the desire of small business owners to control runaway health insurance costs. Many small businesses which previously offered no employee health insurance now offer high deductible health plans to attract new employees and retain current ones. In addition, some employers are forcing employees into high deductible plans by eliminating other health insurance options. Many of these employers are using a portion of their employee health insurance savings to fund deductible employer contributions to employee-owned HSAs.

As a result of increased HSA popularity, competition by HSA providers has resulted in lower or no set up fees, more investment options, and higher rates of interest on HSA balances. For example, in March 2007, one major national bank paid 4% interest on all HSA monthly balances.

Note. There are many websites devoted to HSAs. One site that contains a number of links to HSA providers is **www.HSAfinder.com**. Companies pay HSAfinder.com to list their products on this website. The University of Illinois does not endorse this site or the vendors listed on the site. It is just one of a number of sites created to help taxpayers find HSA providers.

2007 INFLATION ADJUSTMENTS FOR HSAs

Inflation Adjustments for 2007 for High Deductible Health Plans (HDHPs).[13] For HSA purposes, the **minimum** 2007 deductible of an HDHP increases to:

- $1,100 for self-only coverage, and
- $2,200 for family coverage.

The **maximum** 2007 deductible and other out-of-pocket expenses limit for HDHPs increases to:

- $5,500 for self-only coverage, and
- $11,000 for family coverage.

Note. Liberalized rules for 2007 eliminated the requirement that an HDHP be in existence on the first day of each month in order to qualify the taxpayer for an HSA contribution for that month. This favorable change in the law is discussed in the "Deductible HSA Contributions Allowed for Part-Year HDHP Coverage" section shown later.

Inflation Adjustments for Maximum Contributions to an HSA. The deductible limitation for HSA contributions based on the HDHP deductible amount is repealed.[14] For 2007 and 2008, the allowable **maximum** HSA contribution increases to:

	2007	2008[15]
Self-only coverage	$2,850	$2,900
Family coverage	5,650	5,800
Additional contribution for HSA owners age 55 or older and not enrolled in Medicare	800	900

13. IRS Pub. 553, *Highlights of 2006 Tax Changes*

14. IRC §223(b)(2), as amended by TRHCA of 2006

15. Rev. Proc. 2007-36, 2007-22 IRB

Note. The allowable maximum 2007 HSA contribution figures shown above apply regardless of the 2007 HDHP deductible amount. Unlike IRAs, there is no earnings requirement for HSA eligibility.

Inflation Adjustment for HSA Owners who are Age 55 or Older in 2007 and Not Enrolled in Medicare. The additional 2007 HSA contribution allowed to HSA owners age 55 or older as of the end of 2007 increases to $800. This additional contribution is reported on line 7 on the 2007 Form 8889, *Health Savings Accounts.*

Note. In order to deduct the additional $800 HSA contribution for 2007, spouses must have owned separate HSAs. Jointly owned HSAs are not allowed.

Example 3. Fred and Molly, husband and wife, established their separate HSAs in 2005. They have an HDHP with family coverage for all 12 months of 2007. Both are age 60 and retired in 2007. Their former employers made no 2007 contributions to either of their HSAs. The maximum combined HSA contributions they can make in 2007 is $7,250 as shown below.

Normal HSA contribution (family coverage)	$5,650
Additional contribution for Fred	800
Additional contribution for Molly	800
Total allowable 2007 HSA contributions for Fred and Mary	**$7,250**

They can split the maximum $5,650 normal HSA contribution limit any way they choose as long as they both agree. However, each must contribute the additional $800 to their respective HSAs. They make the following 2007 HSA contributions to their separate HSAs:

Taxpayer	Amount of 2007 HSA Contribution
Fred	$4,800 ($4,000 normal contribution + $800 additional contribution)
Molly	2,450 ($1,650 normal contribution + $800 additional contribution)

Note. Even though Fred and Molly have separate HSAs, they can use funds in their individual accounts to pay qualified medical expenses for either spouse and any dependents.

Caution. The draft copy of the 2007 Form 8889 was not available when this book was printed. Therefore, the Forms 8889 shown on pages 18 and 19 are modified versions of the 2006 Form 8889. The 2007 Form 8889 may differ from the ones shown on pages 18 and 19.

For Example 3

Form **8889** | **Health Savings Accounts (HSAs)** | OMB No. 1545-0074
Department of the Treasury Internal Revenue Service | ▶ Attach to Form 1040 or Form 1040NR. ▶ See separate instructions. | **2007** Attachment Sequence No. **53**

Name(s) shown on Form 1040 or Form 1040NR: **Fred**
Social security number of HSA beneficiary. If both spouses have HSAs, see page 2 of the instructions ▶ **555 | 55 | 5555**

Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

Part I **HSA Contributions and Deduction.** See page 2 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse (see page 2 of the instructions).

1	Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2007 (see page 2 of the instructions) ▶ ☐ Self-only ☑ Family		
2	HSA contributions you made for 2007 (or those made on your behalf), including those made from January 1, 2008, through April 16, 2008, that were for 2007. **Do not** include employer contributions, contributions through a cafeteria plan, or rollovers (see page 2 of the instructions)	2	4,800
3	If you were under age 55 at the end of 2007, and on the first day of **every** month during 2007, you were an eligible individual with the **same** annual deductible and coverage, enter the **smaller** of: • Your annual deductible (see page 3 of the instructions), or • $2,850 ($5,650 for family coverage). All others, enter the limitation from the worksheet on page 3 of the instructions	3	4,800
4	Enter the amount you and your employer contributed to your Archer MSAs for 2007 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2007, also include any amount contributed to your spouse's Archer MSAs	4	0
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	4,800
6	Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2007, see the instructions on page 3 for the amount to enter.	6	4,000
7	If you were age 55 or older at the end of 2007, married, and you or your spouse had family coverage under an HDHP at any time during 2007, enter your additional contribution amount (see page 4 of the instructions)	7	800
8	Add lines 6 and 7	8	4,800
9	Employer contributions made to your HSAs for 2007	9	0
10	Subtract line 9 from line 8. If zero or less, enter -0-	10	4,800
11	**HSA deduction.** Enter the **smaller** of line 2 or line 10 here and on Form 1040, line 25, or Form 1040NR, line 25	11	4,800
	Caution: *If line 2 is more than line 11, you may have to pay an additional tax (see page 4 of the instructions).*		

Draft

Part II **HSA Distributions.** If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse.

12a	Total distributions you received in 2007 from all HSAs (see page 5 of the instructions)	12a	
b	Distributions included on line 12a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 12a that were withdrawn by the due date of your return (see page 5 of the instructions)	12b	
c	Subtract line 12b from line 12a	12c	
13	Unreimbursed qualified medical expenses (see page 5 of the instructions)	13	
14	**Taxable HSA distributions.** Subtract line 13 from line 12c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. On the dotted line next to line 21, enter "HSA" and the amount	14	
15a	If any of the distributions included on line 14 meet any of the **Exceptions to the Additional 10% Tax** (see page 5 of the instructions), check here ▶ ☐		
b	**Additional 10% tax** (see page 5 of the instructions). Enter 10% (.10) of the distributions included on line 14 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 63, or Form 1040NR, line 58. On the dotted line next to Form 1040, line 63, or Form 1040NR, line 58, enter "HSA" and the amount	15b	

For Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 37621P Form **8889** (2007)

For Example 3

Form **8889** — Department of the Treasury, Internal Revenue Service

Health Savings Accounts (HSAs)

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

OMB No. 1545-0074 — **2007** — Attachment Sequence No. **53**

Name(s) shown on Form 1040 or Form 1040NR	Social security number of HSA beneficiary. If both spouses have HSAs, see page 2 of the instructions ▶
Molly	**777 | 77 | 7777**

Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

Part I **HSA Contributions and Deduction.** See page 2 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse (see page 2 of the instructions).

Draft

1	Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2007 (see page 2 of the instructions) ▶	☐ Self-only ☑ Family	
2	HSA contributions you made for 2007 (or those made on your behalf), including those made from January 1, 2008, through April 16, 2008, that were for 2007. **Do not** include employer contributions, contributions through a cafeteria plan, or rollovers (see page 2 of the instructions)	2	2,450
3	If you were under age 55 at the end of 2007, and on the first day of **every** month during 2007, you were an eligible individual with the **same** annual deductible and coverage, enter the **smaller** of: • Your annual deductible (see page 3 of the instructions), or • $2,850 ($5,650 for family coverage). All others, enter the limitation from the worksheet on page 3 of the instructions	3	2,450
4	Enter the amount you and your employer contributed to your Archer MSAs for 2007 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2007, also include any amount contributed to your spouse's Archer MSAs	4	0
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	2,450
6	Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2007, see the instructions on page 3 for the amount to enter	6	1,650
7	If you were age 55 or older at the end of 2007, married, and you or your spouse had family coverage under an HDHP at any time during 2007, enter your additional contribution amount (see page 4 of the instructions)	7	800
8	Add lines 6 and 7	8	2,450
9	Employer contributions made to your HSAs for 2007	9	0
10	Subtract line 9 from line 8. If zero or less, enter -0-	10	2,450
11	**HSA deduction.** Enter the **smaller** of line 2 or line 10 here and on Form 1040, line 25, or Form 1040NR, line 25	11	2,450
	Caution: *If line 2 is more than line 11, you may have to pay an additional tax (see page 4 of the instructions).*		

Part II **HSA Distributions.** If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse.

12a	Total distributions you received in 2007 from all HSAs (see page 5 of the instructions)	12a	
b	Distributions included on line 12a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 12a that were withdrawn by the due date of your return (see page 5 of the instructions)	12b	
c	Subtract line 12b from line 12a	12c	
13	Unreimbursed qualified medical expenses (see page 5 of the instructions)	13	
14	**Taxable HSA distributions.** Subtract line 13 from line 12c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. On the dotted line next to line 21, enter "HSA" and the amount	14	
15a	If any of the distributions included on line 14 meet any of the **Exceptions to the Additional 10% Tax** (see page 5 of the instructions), check here ▶ ☐		
b	**Additional 10% tax** (see page 5 of the instructions). Enter 10% (.10) of the distributions included on line 14 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 63, or Form 1040NR, line 58. On the dotted line next to Form 1040, line 63, or Form 1040NR, line 58, enter "HSA" and the amount	15b	

For Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 37621P Form **8889** (2007)

NEW HSA RULES FOR 2007 RETURNS

TRHCA of 2006 made several important changes to HSAs. These changes improve the tax savings element of HSAs and make them more attractive to taxpayers, especially those without employer-subsidized health plans. The following is from a fact sheet about these provisions.[16]

> *This act will bring Health Savings Accounts (HSAs) within the reach of more Americans. HSAs allow people to save money for health care tax-free, and to take these accounts with them if they move from job to job. This act will raise contribution limits and make the accounts more flexible, let people fund their HSAs with one-time transfers from their Individual Retirement Accounts, allow people to contribute up to the annual limit of $2850 regardless of the deductible for their health insurance plan, and give them the option to fully fund their HSAs regardless of what time of year they established the plan.*

1. Deductible HSA Contributions Allowed for Part-Year HDHP Coverage[17]

Old Law. An individual who did not have an HDHP established as of January 1 was not eligible to make HSA contributions for the entire year.

Example 4. Jill established her self-only HDHP on August 1, 2006. The HDHP has a $2,000 annual deductible. Jill's maximum allowable 2006 HSA contribution is limited to $833 ($2,000 × $^5/_{12}$), because she was covered by her HDHP for 5 months of the year.

New Law. An individual who becomes covered under an HDHP at any time during the year is eligible to make HSA contributions for all 12 months of the year.

Example 5. Jack established his self-only HDHP on December 1, 2007. He was not previously covered by an HDHP. **He is entitled to make and deduct a maximum 2007 HSA contribution of $2,850 despite not being covered under the plan for a full year and regardless of his HDHP deductible amount.**

Note. Jack must maintain his HDHP coverage through November 30, 2008, unless he dies or becomes disabled.[18] If he terminates his HDHP in June 2008, he must include $2,613 ($^{11}/_{12}$ of $2,850) in his **2008 AGI** and is subject to a 10% penalty of $261. The $2,613 includable amount for 2008 represents the portion ($^{11}/_{12}$) of his 2007 HSA deduction of $2,850 for the 11 months (January through November of 2007) for which he is treated as an ineligible individual. **He is considered ineligible for the entire year even though he was covered by the HDHP during six months of 2008.**[19]

2. Repeal of Annual HDHP Deductible Limitation for HSA Contribution Purposes[20]

Old Law. The amount of the HDHP deductible was a determining factor in computing the allowable HSA contribution and deduction on Form 8889.

New Law. The amount of the HDHP deductible is ignored in computing the allowable HSA contribution and deduction on Form 8889.

Example 6. Jill established her required self-only HDHP on November 1, 2007. The HDHP has the minimum annual deductible of $1,100. For 2007, Jill is entitled to make and deduct a maximum HSA contribution of $2,850.

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16. "Fact Sheet: Tax Relief and Health Care Act of 2006," Office of the President news release (December 20, 2006)
17. IRC §223(b)(8), as amended by TRHCA of 2006
18. IRC §223(b)(8)(B)
19. IRC §223(b)(8)(i)(I), as amended by TRHCA of 2006
20. IRC §223(b)(2), as amended by TRHCA of 2006

3. One-Time Transfers from a Health Reimbursement Arrangement (HRA) or a Health Flexible Spending Arrangement (FSA) to an HSA Permitted through 2011[21]

New Law.[22] Employers are permitted to make a one-time only direct transfer of HRA or FSA balances to an employee-owned HSA without violating the requirements for those arrangements. The maximum allowable transfer is the **smaller** of the HRA or FSA balance on:

- September 21, 2006, or
- The date of the transfer.

The amount transferred is excludable from the employee's gross income, is not taken into account in applying the HSA contribution limitation, and is not deductible. Employees who receive the HRA or FSA transfer to their HSAs must maintain the required HDHP for 12 months following the month of the transfer unless the employee dies or becomes disabled. If the plan is not maintained, the transferred amount becomes taxable and subject to a 10% penalty.

Sunset Provision. The transfers must be made directly to the HSA no later than December 31, 2011.

4. One-Time Direct Transfer from an IRA to an HSA Permitted.[23]

New Law. Taxpayers can make a one-time-only direct trustee-to-trustee transfer from an IRA (other than a SIMPLE IRA or a SEP IRA) to their HSA. The maximum allowable amount transferred is the taxpayer's maximum allowable HSA contribution for the year of the transfer. The amount of the IRA transfer is:

- Excludable from gross income,
- Not deductible as an HSA contribution, and
- Not subject to the 10% early distribution penalty on IRA withdrawals.

However, the amount transferred reduces the applicable maximum HSA contribution allowed for the year of transfer.

Note. The taxpayer who transfers IRA funds to his HSA must maintain the required HDHP for 12 months following the month of the transfer. If not, the transfer is taxable and subject to a 10% penalty except for death or disability.

Example 7. Karen and Joe, a married couple with two dependent children, established a family-coverage HDHP in 2005. The HDHP is their only health insurance plan in 2007. Both are age 45 in 2007.

Karen had a traditional IRA balance of $100,000 as of December 31, 2006. Joe does not have an IRA or an HSA. Karen established her HSA on January 1, 2005, in conjunction with the commencement of their family-coverage HDHP.

Instead of using funds from savings to fund her maximum allowable 2007 HSA contribution, Karen instructed her IRA trustee to transfer $5,650 to the trustee of her HSA. This was done on December 20, 2007. This transfer was Karen's only 2007 IRA distribution.

1. The $5,650 IRA distribution is excludable from Karen and Joe's 2007 gross income.
2. Karen is not entitled to deduct the $5,650 as an HSA contribution on her 2007 Form 8889.
3. Karen is not subject to the 10% early distribution penalty of $565 on her $5,650 IRA transfer amount.
4. After 2007, Karen will be ineligible for a similar transfer from her IRA to her HSA.

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21. IRC §106(e), as amended by TRHCA of 2006
22. IRS Pub. 553, *Highlights of 2006 Tax Changes*, Rev. March 2007
23. IRC §408(d)(9), as amended by TRHCA of 2006

> **Note.** Since HSA funds used to pay medical expenses are tax-free, HSA funds are more tax-advantaged than IRA funds. However, in this example, Karen loses her potential 2007 HSA deduction of $5,650. **If Karen and Joe are in the 28% federal tax bracket, their 2007 federal tax liability will be $1,582 higher (Karen's lost $5,650 HSA deduction × 28%).** Their 2007 state income tax liability will also be higher — $170 higher if they live in Illinois ($5,650 × 3%).

5. Larger HSA Contributions for Non–Highly Compensated Employees after 2006

Employers who contribute to employee HSA plans may not discriminate between comparable participating employees. The contributions must be comparable, meaning the same amount or the same percentage of compensation. TRHCA now allows an employer to make a larger contribution to a non–highly compensated employee's HSA, than to a highly compensated comparable employee.

Highly compensated employees include any employee who:

1. Is a 5% owner at any time during the year or preceding year, or
2. For the preceding year:
   a. Had compensation in excess of $80,000, and
   b. If elected by the employer, was in the top paid group.

TRHCA continues to prevent discrimination between non–highly compensated employees. These rules became effective for tax years beginning after December 31, 2006.

Conclusion. HSAs were already attractive and becoming more popular before the enactment of TRHCA. With the added benefits of TRHCA, HSAs are greatly improved. It is likely that the number of HSAs will increase at an even higher rate in 2007 and future years, particularly for those taxpayers who must provide their own unsubsidized health insurance prior to enrolling in Medicare.

> **Note.** See the "Deductions" section of Chapter 15, "Ruling and Cases," for the 2008 HSA and HDHP inflation-adjusted numbers. These numbers were released by the IRS via Rev. Proc. 2007-36. Information regarding rollovers to HSAs is also found in the same section under the description for IRS Notice 2007-22.

PROBLEM 3: INVESTMENT INTEREST EXPENSE

BACKGROUND INFORMATION

The passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 resulted in two positive trends regarding individual income tax returns:

1. The amount of capital gains reported dramatically increased from the pre-act year of 2002 compared to the post-act years of 2003 through 2005. The latest tax year for which the IRS has released data is 2005. **According to IRS statistics, the amount of reported net capital gain income increased by 36.7% in 2005 from what was similarly reported on 2004 returns.**[24] Net capital gain income is equal to the excess of net long-term capital gains over net short-term capital losses.

Tax Year	Net Capital Gain Income Reported (all individual returns)
2004	$442.1 billion
2005	604.4 billion (36.7% increase)

Net capital gain income was the second largest component of 2005 AGI. It was surpassed only by salaries and wages.

2. The amount of qualified dividend income has also risen rapidly. **According to IRS statistics, the amount of reported qualified dividends increased by 9% in 2005 from what was reported on 2004 returns.**[25]

It is anticipated that this trend will continue for 2007 individual tax returns. **Therefore, the planning decision to make the special election to treat all or part of net capital gains and/or qualified dividends as investment income on 2007 returns might be a more common one for tax practitioners to consider**. Of course, this planning decision is necessary only when a client pays investment interest. The election is made on line 4g on Form 4952, *Investment Interest Expense Deduction.*

EXPLANATION OF TAX LAW

IRC §163(d), which is entitled *Limitation on Investment Interest*, governs the deductibility of investment interest. Form 4952 is used to compute the deduction unless the following exception applies:

Investment Income and Expenses (For use in preparing 2006 returns), excerpted from IRS Pub. 550.

Exception to use of Form 4952. *You do not have to complete Form 4952 or attach it to your return if you meet all of the following tests.*

- *Your investment interest expense is not more than your investment income from interest and ordinary dividends minus any qualified dividends.*
- *You do not have any other deductible investment expenses.*
- *You have no carryover of investment interest expense from 2005.*

If you meet all of these tests, you can deduct all of your investment interest.

24. "Winter of 2006–2007 Statistics of Income Bulletin," IRS News Release IR-2007-55 (March 12, 2007)

25. Ibid.

Form **4952** Department of the Treasury Internal Revenue Service (99)	**Investment Interest Expense Deduction** ▶ Attach to your tax return.	OMB No. 1545-0191 2007 Attachment Sequence No. **51**
Name(s) shown on return		**Identifying number**

Part I Total Investment Interest Expense

1	Investment interest expense paid or accrued in 2007 (see instructions)		1	
2	Disallowed investment interest expense from 2006 Form 4952, line 7		2	
3	**Total investment interest expense.** Add lines 1 and 2		3	

Part II Net Investment Income

4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)	4a		
b	Qualified dividends included on line 4a	4b		
c	Subtract line 4b from line 4a		4c	
d	Net gain from the disposition of property held for investment	4d		
e	Enter the **smaller** of line 4d or your net capital gain from the disposition of property held for investment (see instructions)	4e		
f	Subtract line 4e from line 4d		4f	
g	Enter the amount from lines 4b and 4e that you elect to include in investment income (see instructions)		4g	
h	Investment income. Add lines 4c, 4f, and 4g		4h	
5	Investment expenses (see instructions)		5	
6	**Net investment income.** Subtract line 5 from line 4h. If zero or less, enter -0-		6	

Part III Investment Interest Expense Deduction

7	Disallowed investment interest expense to be carried forward to 2008. Subtract line 6 from line 3. If zero or less, enter -0-		7	
8	**Investment interest expense deduction.** Enter the **smaller** of line 3 or 6. See instructions		8	

Definition of Investment Interest. Generally, investment interest is loan interest paid to buy property held for investment. Property held for investment includes property not derived in the ordinary course of a trade or business that produces the following types of income:

- Interest,
- Dividends,
- Annuities, or
- Royalties.

Investment property does not include an investment in a passive activity.

Example 8. Juan owns stock in various domestic corporations and 20 acres of bare land held for appreciation. He borrowed money from his brokerage firm to buy a portion of the stock. He also borrowed money from a bank to buy the 20 acres. He paid the following interest in 2007:

- $2,000 of margin interest paid to his brokerage firm, and
- $3,000 of the mortgage interest paid to the bank on the loan to buy the land.

Juan's 2007 investment interest expense is $5,000. He enters $5,000 on line 1 of Form 4952. His deduction of the $5,000 may be limited by the rules for deducting investment interest. Depending on other facts, he may have to attach a Form 4952 to his 2007 tax return.

Interest Expense That Does Not Constitute Investment Interest Expense. The following types of interest expense do not represent investment interest and should therefore be omitted on line 1 of Form 4952:

1. Qualified home mortgage interest properly deducted on lines 10 and 11 of Schedule A;
2. Interest expense that is properly allocable to a passive activity;
3. Interest on loans if the loan proceeds are used to buy tax-exempt securities;
4. Any interest expense that is capitalized, such as construction interest; and
5. Interest expense, disallowed under §264, on indebtedness related to life insurance, endowment, or annuity contracts issued after June 8, 1997.

Example 9. Assume in **Example 8** that Juan owns both domestic stocks and tax-exempt municipal bond funds in his brokerage account. The $2,000 of margin interest he paid his brokerage firm in 2007 includes $1,000 of interest on margin loans used specifically to buy two tax-exempt municipal bond funds.

Juan's 2007 investment interest expense is $4,000. He enters $4,000 on line 1 on his 2007 Form 4952.

Making the Election on Line 4g, Form 4952. An important election may be made on line 4g on Form 4952. Investment income generally does **not** include:

1. Qualified dividends, reported on line 9b, Form 1040, or
2. Net capital gains from the disposition of investment property, including capital gain distributions from mutual funds.

However, taxpayers may make an election to treat net capital gains from the sale of investment property and qualified dividends as investment income. **Making the election may increase the amount of the current year investment interest deduction.**

Planning Tip. Short-term capital gains can help taxpayers maximize their investment interest deduction. These gains are included as investment income on line 4d, Form 4952. However, net long-term gains aren't included as investment income unless the election is made on line 4g, Form 4952.

If the election is made, any net capital gains and/or qualified dividends included on line 4g, Form 4952 would not be eligible for the lower 15% or 5% tax rates.

The election generally must be made on a timely filed return, **including** extensions. However, if the election is not made and the return is timely filed without extension, the taxpayer can make the election on an amended return filed within six months of the original due date, **excluding** extensions. The election can only be revoked with IRS consent.[26]

Note. See page 622 in the 2006 *University of Illinois Federal Tax Workbook* for an analysis of Letter Ruling 200620018, which provides guidance on late elections.

[26] Treas. Reg. §1.163(d)-1(c)

Advantage of Making the Election for 2007. For taxpayers in the 25% and higher tax brackets who itemize deductions in 2007, the tax savings equal 15% of the amount elected on line 4g of Form 4952. This assumes that the increase in the investment interest deduction (line 14, Schedule A) equals the amount elected to be included in investment income (line 4g, Form 4952).

Planning Tip. Making the election is most effective when total of interest, dividend, and annuity income (line 4a, Form 4952) is **equal to or less than the total of**:

- Net capital gain from the sale of investment property like stocks (line 4e, Form 4952), and
- Qualified dividends (line 4b, Form 4952).

Example 10. Pat and Ellen file jointly, have no dependents, and itemize deductions. They paid $4,000 of margin interest to their brokerage firm in 2007. They borrowed money from the brokerage firm to buy domestic stock. The margin interest is their only 2007 investment expense. They had no carryover of disallowed investment interest expense from 2006 to 2007.

Their 2007 income consists of:

Wages	$150,000
Interest income	1,500
Qualified dividends	500
Long-term capital gains on six stock sales	46,000
Short-term capital loss on one stock sale	(6,000)
Adjusted gross income for 2007	**$192,000**

They make the election on line 4g of Form 4952 to include $2,500 of their $40,000 net capital gain ($46,000 long-term gain minus $6,000 short-term loss) as investment income. By making the election, they are allowed to deduct the entire $4,000 of margin interest on Schedule A. Their 2007 Form 4952 is shown on the next page.

For Example 10

Form **4952** — Department of the Treasury, Internal Revenue Service (99)

Investment Interest Expense Deduction

▶ Attach to your tax return.

OMB No. 1545-0191 — **2007** — Attachment Sequence No. **51**

Name(s) shown on return: **Pat and Ellen** — Identifying number: **444-44-4444**

Part I Total Investment Interest Expense

1	Investment interest expense paid or accrued in 2007 (see instructions)			1	4,000
2	Disallowed investment interest expense from 2006 Form 4952, line 7			2	
3	**Total investment interest expense.** Add lines 1 and 2			3	4,000

Part II Net Investment Income

4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)	4a	2,000		
b	Qualified dividends included on line 4a	4b	500		
c	Subtract line 4b from line 4a			4c	1,500
d	Net gain from the disposition of property held for investment	4d	40,000		
e	Enter the **smaller** of line 4d or your net capital gain from the disposition of property held for investment (see instructions)	4e	40,000		
f	Subtract line 4e from line 4d			4f	0
g	Enter the amount from lines 4b and 4e that you elect to include in investment income (see instructions)			4g	2,500
h	Investment income. Add lines 4c, 4f, and 4g			4h	4,000
5	Investment expenses (see instructions)			5	0
6	**Net investment income.** Subtract line 5 from line 4h. If zero or less, enter -0-			6	4,000

Part III Investment Interest Expense Deduction

7	Disallowed investment interest expense to be carried forward to 2008. Subtract line 6 from line 3. If zero or less, enter -0-	7	
8	**Investment interest expense deduction.** Enter the **smaller** of line 3 or 6. See instructions.	8	4,000

Because their 2007 AGI exceeds $156,400, their itemized deductions are reduced by the phaseout computation found in the Form 1040 instructions worksheet. This reduced amount is entered on Schedule A, line 28.

Total itemized deductions before phaseout	$32,700
Phaseout reduction amount from worksheet (not shown)	(712)
Allowable itemized deductions	$31,988

For Example 10

SCHEDULES A&B (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Schedule A—Itemized Deductions** (Schedule B is on back) ▶ Attach to Form 1040. ▶ See Instructions for Schedules A&B (Form 1040).	OMB No. 1545-0074 2007 Attachment Sequence No. 07

Name(s) shown on Form 1040: Pat and Ellen | Your social security number: 444 44 4444

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-1)	1			
	2	Enter amount from Form 1040, line 38 [2]				
	3	Multiply line 2 by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	
Taxes You Paid (See page A-2.)	5	State and local **(check only one box):** a ☒ Income taxes, **or** b ☐ General sales taxes	5	7,500		
	6	Real estate taxes (see page A-5)	6	8,200		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	15,700
Interest You Paid (See page A-5.)	10	Home mortgage interest and points reported to you on Form 1098	10	12,000		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-6 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-6 for special rules	12			
	13	Qualified mortgage insurance premiums (See page A-7)	13			
	14	Investment interest. Attach Form 4952 if required. (See page A-7.)	14	4,000		
	15	Add lines 10 through 14			15	16,000
Gifts to Charity If you made a gift and got a benefit for it, see page A-7.	16	Gifts by cash or check. If you made any gift of $250 or more, see page A-8	16	1,000		
	17	Other than by cash or check. If any gift of $250 or more, see page A-8. You **must** attach Form 8283 if over $500	17			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	1,000
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See page A-9.)			20	
Job Expenses and Certain Miscellaneous Deductions (See page A-9.)	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-9.) ▶	21			
	22	Tax preparation fees	22			
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23			
	24	Add lines 21 through 23	24			
	25	Enter amount from Form 1040, line 38 [25]				
	26	Multiply line 25 by 2% (.02)	26			
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	
Other Miscellaneous Deductions	28	Other—from list on page A-9. List type and amount ▶			28	
Total Itemized Deductions	29	Is Form 1040, line 38, over $156,400 (over $78,200 if married filing separately)? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. ☒ **Yes.** Your deduction may be limited. See page A-10 for the amount to enter. ▶			29	31,988
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐				

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2007**

Making the election increases their itemized deductions and thus reduces their taxable income by $2,500. Their 2007 Form 1040 will show:

Adjusted gross income	$192,000
Less: itemized deductions after reduction	(31,988)
Less: personal exemptions ($3,400 × 2)	(6,800)
Taxable income	**$153,212**

If the election was **not** made, the result would be:

- Itemized deductions of $29,488 after reduction **($2,500 less),** and
- Taxable income of $155,712 **($2,500 more).**

Pat and Ellen are in the 28% tax bracket for 2007.

Computation of Regular Tax with Election	
$37,500 of net capital gain + $500 of qualified dividends = $38,000 × 15%	$ 5,700
Tax on $115,212 of remaining taxable income using Tax Computation Worksheet	21,651
Tax with election	**$27,351**

Computation of Regular Tax without Election	
$40,000 of net capital gain + $500 of qualified dividends = $40,500 × 15%	$ 6,075
Tax on $115,212 of remaining taxable income using Tax Computation Worksheet	21,651
Tax without election	**$27,726**

Their tax, with the election, is $375 less than if the election had not been made. **The tax savings of $375 equals 15% of the $2,500 elected amount on line 4g, Form 4952.**

Note. AMT may reduce the $375 tax savings.

Observations

1. According to the Form 4952 Instructions, the $2,500 elected amount (line 4g) is "generally treated as being attributable first" to the $40,000 net capital gain (line 4e), "and then to qualified dividends (line 4b). This treatment results in the least tax being figured for Form 1040." The **Computation of Tax with Election** shown above follows this ordering rule because the $2,500 elected amount was used to reduce the $40,000 net capital gain.

2. If the election had not been made for 2007, Pat and Ellen's deduction for investment interest would have been limited to $1,500, the amount shown on line 4c of Form 4952 (page 27). However, the disallowed $2,500 of 2007 investment interest ($4,000 total minus $1,500 allowed as a deduction) would be carried over to their 2008 return.

3. If Pat and Ellen expect to have ample investment income in 2008, it may be wise for them to forgo the $2,500 election for 2007. This is especially true if they expect their 2008 taxable income to be significantly higher than their 2007 taxable income.

PROBLEM 4: PHASEOUTS AND LIMITATIONS

BACKGROUND INFORMATION

The often-lamented complexity of the Internal Revenue Code can be aptly demonstrated by the maze of phaseout and limitation provisions. Many **low-income families** actually receive tax subsidies in the form of a negative tax liability. This is due mainly to the effects of the earned income credit and the refundable portion of the child tax credit.

Conversely, the effective tax rate on taxable income of **high-income families** is often higher than their statutory tax rate due to phaseouts of the following:

- Itemized deductions,
- Personal exemptions, and
- Tax credits (for example, education credits on Form 8863).

> **Note.** Many **middle-income families** face higher effective tax rates due to the AMT. That's especially true for families with many children or those who live in states with high real estate and/or income taxes.

2007 PHASEOUTS

Following is a nonexclusive list of phaseouts and limitations. Fortunately, tax software automatically calculates these phaseouts and limitations, sparing practitioners the time-consuming manual computations required when using the numerous worksheets contained in the Form 1040 Instructions.

2007 AGI Phaseout Range for Personal Exemptions

Joint Filers	Single	Head of Household	Married Filing Separately
$234,600–357,100	$156,400–278,900	$195,500–318,000	$117,300–178,550

> **Caution.** For 2007, exemptions cannot be fully phased out as explained in the **Note** below. This phaseout for high-income taxpayers is gradually being phased out and **is eliminated for 2010 and later tax years.**[27] However, future legislation could reinstate the phaseout.

> **Note.** The deduction for personal exemptions is phased out by 2% for each $2,500 of 2007 AGI which exceeds the threshold amount.[28] However, for the **2006 and 2007 tax years**, the **nondeductible** amount of personal exemptions is limited to ²⁄₃ of the disallowed amount. **Therefore, ¹⁄₃ of the 2007 exemption amount, or $1,133 will still be deductible by taxpayers whose 2007 AGI exceeds the upper limit amounts.** For the **2008 and 2009 tax years**, the **nondeductible** amount is limited to ¹⁄₃ of the disallowed amount.

27. IRC §151(d)(3)(F)

28. IRC §151(d)(3)(E)

2007 AGI Phaseout for Itemized Deductions

Joint Filers	Single	Head of Household	Married Filing Separately
$156,400 and up	$156,400 and up	$156,400 and up	$78,200 and up

Caution. For 2007, the calculation of this phaseout is modified as explained below. This phaseout for high-income taxpayers is also being phased out and **is eliminated for 2010 and later tax years** unless changed by future legislation.[29]

The deduction for the total of itemized deductions is reduced by 3% of 2007 AGI that exceeds $156,400. The reduction is limited to 80% of the total and does not apply t**o investment interest, medical expenses, or casualty losses. However, for the 2006 and 2007 tax years,** the reduction is limited to ²⁄₃ of the disallowed amount. For the **2008 and 2009 tax years**, the reduction is limited to ¹⁄₃ of the disallowed amount.

2007 AGI Phaseout Range for Education Credits

Joint Filers	Single	Head of Household	Married Filing Separately
$94,000–114,000	$47,000–57,000	$47,000–57,000	N/A

The maximum 2007 Hope credit is **$1,650** for **each eligible student**. The maximum 2007 Lifetime Learning credit is **$2,000 per return**, regardless of the number of students. Taxpayers are not permitted to claim both credits for the **same student**. Married taxpayers filing separately cannot claim either credit.

2007 AGI Phaseout Range for Student Loan Interest

Joint Filers	Single	Head of Household	Married Filing Separately
$110,000–140,000	$55,000–70,000	$55,000–70,000	N/A

The maximum 2007 student loan interest deduction is **$2,500 per return**. Married couples filing jointly (MFJ) in 2007 are limited to the $2,500 maximum limit even if both pay student loan interest. Married taxpayers filing separately and a person who is claimed as a dependent by another taxpayer (such as parents) cannot claim the deduction.

2007 AGI Phaseout Range for Tuition and Fees Deduction

Joint Filers	Single	Head of Household	Married Filing Separately
$130,000–160,000	$65,000–80,000	$65,000–80,000	N/A

A **$4,000 deduction** may be claimed if AGI does **not exceed** $130,000 for MFJ taxpayers or $65,000 for other taxpayers. A **$2,000 deduction** may be claimed if AGI is in the phaseout ranges shown in the above chart. Married taxpayers filing separately and a person who may be claimed as a dependent by another taxpayer (such as parents) cannot claim the deduction.

29. IRC §§68(f) and (g)

2007 AGI Phaseout Range for the Adoption Credit

Joint Filers	Single	Head of Household	Married Filing Separately
$170,820–210,820	$170,820–210,820	$170,820–210,820	N/A

The maximum 2007 adoption credit allowed is $11,390. Married taxpayers filing separately generally are prohibited from claiming the credit.

2007 AGI Phaseout Ranges for the Retirement Savers Credit

Credit Rate	Joint Filers	Single	Head of Household	Married Filing Separately
50%	Up to $31,000	Up to $15,500	Up to $23,500	Up to $15,500
20%	$31,001–34,000	$15,501–17,000	$23,251–25,500	$15,501–17,000
10%	$34,001–52,000	$17,001–26,000	$25,501–39,000	$17,001–26,000

2007 AGI Limit for the $1,000 Child Tax Credit

Joint Filers	Single	Head of Household	Married Filing Separately
$110,000	$75,000	$75,000	$75,000

The child tax credit may be **refundable depending on the number of qualifying children and the amount of the taxpayer's earned income.** This additional child tax credit is claimed on Form 8812. **Example 13**, which is shown later, includes a completed 2007 Form 8812.

Note. As of the date this book was printed, Congress had taken no action regarding the 2007 AMT exemption amounts. Based on the best information available, it is likely that Congress will pass and the president will sign legislation that keeps the 2007 AMT exemption amounts at their 2006 levels. The 2007 AMTI threshold/upper limit amounts for the phaseout of the 2007 AMT exemption shown next uses that assumption. Any corrections to these 2007 amounts will be posted on the University of Illinois Tax School website.

2007 Alternative Minimum Taxable Income Phaseout Range for AMT Exemption Amounts[a]

Joint Filers	Single	Head of Household	Married Filing Separately
$150,000–$400,200	$112,500–$282,500	$112,500–$282,500	$75,000–200,100

[a] AMTI is the amount reported on line 28, Form 6251.

Note. The minimum 2007 AMT exemption amount for a child under age 18 has increased to $6,300.

The following example demonstrates how three of the 2007 phaseout rules affect a high-income taxpayer.

Note. Example 11 assumes that the 2007 AMT exemption amount for married taxpayers who file jointly remains at the 2006 AMT exemption amount of $62,550.

Example 11. Reid and LuAnn, who reside in Indiana, file a joint 2007 tax return. They claim two personal exemptions and they itemize deductions. Their 2007 AGI consists of the following:

Wages		$240,000
Interest income		7,000
Dividends ($5,000 are qualifying)		15,000
Capital gains (all long-term)		70,000
Rental real estate profit		15,000
2007 AGI		**$347,000**
Total itemized deductions before and after phaseouts:		
State income tax	$ 3,000	
Real estate taxes	7,000	
Contributions	14,000	
Itemized deductions before phaseout	$24,000	
Less phaseout amount	(3,812)	
Itemized deductions after phaseout	$20,188	(20,188)
Exemptions before phaseout (2 × $3,400)	$ 6,800	
Less phaseout amount	(4,080)	
Exemptions after phaseout	$ 2,720	(2,720)
Taxable income after phaseouts		**$324,092**

Regular tax (after the two phaseouts)	$72,650
AMT (after the two phaseouts)	2,636
Total 2007 tax (after the two phaseouts)	**$75,286**

Observations

1. Reid and LuAnn are subjected to three phaseouts for 2007:
   - A $3,812 reduction of their otherwise allowable itemized deductions of $24,000
   - A $4,080 reduction of their otherwise allowable exemption deduction of $6,800
   - A $45,750 reduction of their otherwise allowable AMT exemption of $62,550 as explained in Observation 2.
2. Although the 2007 Form 6251 is not shown, Reid and LuAnn are subjected to a phaseout of their AMT exemption.

2007 AMT exemption before phaseout	$62,550
2007 AMT exemption after phaseout	$16,800

3. Assume that $60,000 of the $70,000 of long-term capital gains was realized in December 2007. The detrimental tax effects of the three phaseouts might have been lessened if the December 2007 gains were delayed until 2008. If the taxpayers anticipate that their 2008 taxable income will be significantly lower than it is for 2007, this planning suggestion is advisable.

Note. When high-income taxpayers have managed brokerage accounts or they rely heavily on the investment advice of their brokers, there may be a tendency to sell securities in December to generate long-term capital gains. If so, it is best to do this **after** the taxpayer has consulted his tax practitioner.

The use of the installment sale method can also be used to lessen the detrimental tax effects of phaseouts. Of course, the installment sale method is not allowed for the sale of publicly-traded securities.

4. Under present law, the phaseouts of personal exemptions and itemized deductions are eliminated after 2009.

2007 LIMITATIONS

Earned Income Credit (EIC)

1. **Amount of Credit Increased.** The maximum amount of the 2007 credit has increased to:
   - $2,853 for one qualifying child,
   - $4,716 for two or more qualifying children, and
   - $428 for no qualifying child.
2. **Earned Income/AGI Amounts Increased.** The maximum amount of 2007 adjusted gross income (AGI) and earned income a taxpayer may have and still get the credit has increased. The 2007 credit is available if income **and** AGI are less than:
   - $37,783 for taxpayers with two or more qualifying children ($39,783 for married taxpayers who file a joint 2007 return);
   - $33,241 for taxpayers with one qualifying child ($35,241 for married taxpayers who file a joint 2007 return); and
   - $12,590 for taxpayers with no qualifying children ($14,590 for married taxpayers who file a joint 2007 return).

Note. Taxpayers may **not** have **earned** income exceeding the above maximum income amounts. For example, a single taxpayer with no children and a 2007 AGI of $11,000 consisting of wages of $14,000 and a capital loss of $3,000 cannot qualify for the EIC.

3. **Phaseout Thresholds Increased.** The credit begins to phaseout if either 2007 earned income or AGI equals or exceeds:
   - $15,390 for single or head of household filers with one or more qualifying children;
   - $17,390 for married filing jointly taxpayers with one or more qualifying children;
   - $7,000 for single or head of household filers with no qualifying children; and
   - $9,000 for married filing jointly taxpayers with no qualifying children.
4. **Maximum Amount of Earned Income on Which the Credit Is Based Increased.** The maximum 2007 earned income amounts are:
   - $11,790 for taxpayers with two or more qualifying children,
   - $8,390 for taxpayers with one qualifying child, and
   - $5,590 for taxpayers with no qualifying children.
5. **Investment Income Amount Increased.** The maximum amount of 2007 investment income a taxpayer may have and still get the credit has increased to $2,900.

The following example demonstrates the application of the **2007** changes to the earned income credit and the additional (refundable) child tax credit.

Example 12. Kimberly is a 34-year-old single mother of two children:

- Daughter Karen was born in 2000 (age 7).
- Son Cody was born in 2002 (age 5).

Kimberly qualifies as **head of household** and reports the following on her **2007** Form 1040:

Wages, line 7	$15,000
Unemployment compensation, line 19	2,000
2007 AGI	$17,000
Less: standard deduction	(7,850)
Less: exemptions ($3,400 × 3)	(10,200)
2007 taxable income	$ 0

Kimberly's 2007 Form W-2 shows the following withheld amounts:

- Federal income tax of $600 (Box 2),
- Social security tax of $930 (Box 4), and
- Medicare tax of $ 218 (Box 6).

Question 12A. What is the amount of Kimberly's refund for 2007?

Answer 12A. $5,460, calculated as follows:

Federal income tax withheld	$ 600
Earned income credit (based on AGI of $17,000 with two children)	4,372
Additional child tax credit (Form 8812)	488
Amount of Kimberly's 2007 Form 1040 refund	**$5,460**

For Example 12

Form **8812**

Department of the Treasury
Internal Revenue Service (99)

Additional Child Tax Credit

1040 / 1040A / 1040NR — 8812

Complete and attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-0074

2007

Attachment Sequence No. **47**

Name(s) shown on return: **Kimberly**

Your social security number: **555 55 5555**

Part I All Filers

1	Enter the amount from line 1 of your Child Tax Credit Worksheet on page 43 of the Form 1040 instructions, page 38 of the Form 1040A instructions, or page 20 of the Form 1040NR instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 4 of the publication		**2,000**
2	Enter the amount from Form 1040, line 52, Form 1040A, line 32, or Form 1040NR, line 47		**0**
3	Subtract line 2 from line 1. If zero, **stop**; you cannot take this credit		**2,000**
4a	Enter your total earned income (see instructions on back)	**15,000**	
b	Nontaxable combat pay (see instructions on back) — 4b		
5	Is the amount on line 4a more than $11,750? ☐ **No.** Leave line 5 blank and enter -0- on line 6. ☒ **Yes.** Subtract $11,750 from the amount on line 4a. Enter the result	**3,250**	
6	Multiply the amount on line 5 by 15% (.15) and enter the result		**488**

Next. Do you have three or more qualifying children?

☒ **No.** If line 6 is zero, stop; you cannot take this credit. Otherwise, skip Part II and enter the **smaller** of line 3 or line 6 on line 13.

☐ **Yes.** If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.

Part II Certain Filers Who Have Three or More Qualifying Children

7	Withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see instructions on back		
8	**1040 filers:** Enter the total of the amounts from Form 1040, lines 27 and 59, plus any taxes that you identified using code "UT" and entered on the dotted line next to line 63. **1040A filers:** Enter -0-. **1040NR filers:** Enter the total of the amounts from Form 1040NR, line 54, plus any taxes that you identified using code "UT" and entered on the dotted line next to line 58.		
9	Add lines 7 and 8		
10	**1040 filers:** Enter the total of the amounts from Form 1040, lines 66a and 67. **1040A filers:** Enter the total of the amount from Form 1040A, line 40a, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 42 (see instructions on back). **1040NR filers:** Enter the amount from Form 1040NR, line 61.		
11	Subtract line 10 from line 9. If zero or less, enter -0-		
12	Enter the **larger** of line 6 or line 11		

Next, enter the **smaller** of line 3 or line 12 on line 13.

Part III Additional Child Tax Credit

13	**This is your additional child tax credit**	**488**

1040 / 1040A / 1040NR

Enter this amount on Form 1040, line 68, Form 1040A, line 41, or Form 1040NR, line 62.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10644E Form **8812** (2007)

Observations

- Since Kimberly's $17,000 AGI exceeds her $15,000 earned income, her EIC is based on the larger AGI figure. Schedule EIC must be attached to her 2007 return.
- Kimberly's **nonrefundable** $2,000 child tax credit is meaningless because her total tax was zero. However, since her $15,000 of earned income exceeded $11,750, she is entitled to a **refundable** child tax credit of $488 as shown on Form 8812. The refundable portion of her child tax credit equals 15% of the amount by which her earned income exceeds $11,750.
- If Kimberly had **three** children under 17 rather than two, her refund would be the same. Her additional child tax credit would remain at $488 because her EIC of $4,372 exceeds her combined FICA and Medicare tax withholding of $1,148.

Note. According to preliminary statistics,[29] the total amount of earned income credit (EIC) reported on 2005 tax returns was **$43.1 billion**, which is a **6.1% increase** over the EIC claimed on 2004 returns. The EIC was claimed on the 2005 returns of **23 million** taxpayers.

Gift Tax Exclusion

The annual gift tax exclusion amount per donee remains at $12,000 for 2007.

Long-Term Care Insurance Premiums

For 2007, the maximum amount of qualified long-term care premiums that can be included as medical expense has increased. The premiums can be included, up to the amounts shown in the chart below.

Policyholder's Age as of December 31, 2007	Maximum Deduction Allowable as a Medical Expense
Age 40 or under	$ 290
Age 41 to 50	550
Age 51 to 60	1,110
Age 61 to 70	2,950
Age 71 or over	3,680

Example 13. Les, age 52, and Linda, age 47, file a joint 2007 return and incurred substantial unreimbursed medical expenses, including:

- Lester's long-term care insurance premiums of $1,400, and
- Linda's long-term insurance premiums of $850.

Question 13A. What amount are Les and Linda allowed to include as medical expenses on their 2007 Schedule A?

Answer 13A. $1,660 ($1,110 + $550)

30. "Winter 2006–2007 Statistics of Income Bulletin," IRS News Release IR-2007-55 (March 12, 2007)

IRC §179 Deduction

The maximum §179 deduction that can be elected for 2007 has increased to **$125,000**.[31]

If the cost of qualified property placed in service in 2007 is more than $500,000, the §179 deduction limit is reduced by the portion of the cost exceeding $500,000.

Capital Loss Limitation

The $3,000 capital loss limitation on Schedule D remains unchanged in 2007.

PROBLEM 5: COAL ROYALTY PAYMENTS

BACKGROUND INFORMATION

Coal mining in many Midwestern states, including Illinois, has declined significantly in the past 50 years. The main reason for the production decline is EPA emission standards, which have made the use of high-sulfur coal, especially by electric utility companies, more expensive. As a result, low-sulfur coal from Western states has often been used as a substitute.

However, new technologies have lessened the undesirable environmental impact of all types of coal. Consequently, coal mining companies are showing a renewed interest in obtaining coal leases from landowners.

> **Note.** Illinois has approximately 21% of the U.S. Demonstrated Coal Reserves base, or about a half billion short tons of coal.[32]

FAVORABLE CAPITAL GAIN TREATMENT FOR COAL ROYALTY PAYMENTS

Coal royalties may be treated as capital gain income if:[33]

1. The coal is actually mined under the contract, and
2. An economic interest in the coal is retained.

This is true for both advanced royalty payments and earned royalty payments.

If the economic interest requirement is met, the coal is considered used in a trade or business if the coal rights have been owned for more than one year prior to the date the **coal is mined**.[34] This is true even if the **contract is signed prior** to the more-than-one-year test being met.[35]

> **Caution.** The treatment described in this section is not allowed if the royalties are received from a **related party**. In addition to related parties as defined under the rules for disallowing losses, brother-sister and parent-child entities are also prohibited from using this method.[36]

Retention of Economic Interest.[37] The owner of coal has **retained an economic interest** if both of the following apply:

1. She has an investment interest in the coal deposits.
2. She has a legal right to income from the **extraction** of the coal.

31. As increased by the Small Business and Work Opportunity Tax Act of 2007, enacted on May 25, 2007
32. National Mining Association, "U.S. Coal Reserves by State and Type: 2005," updated November 2006, www.nma.org/pdf/c_reserves.pdf
33. IRC §631(c) and Treas. Reg. §1.631-3(a)
34. Treas. Reg. §1.631-3(a)(2) and IRC §1231(b)(2)
35. Treas. Reg. §1.631-3(b)(1)
36. IRC §631(c)
37. Treas. Reg. §1.611-1(b), and IRS Pub. 535, *Business Expenses.*

Example 14. Sally owns land in southern Illinois, which she purchased in 1980. The mineral rights are included in her land ownership. She enters into a coal lease with Peabody Coal Company in 2007. The terms of the lease call for a coal royalty payment of $10 per ton of actual coal mined. Sally has retained an economic interest and she will be entitled to capital gain treatment on her receipt of coal royalty income.

Example 15. John Birge owns **500 acres** of farmland, which he purchased in March 1990 for $500,000, or $1,000 per acre. John was not aware of any coal deposits under the land when he purchased the 500 acres. The purchase contract did not allocate any of the $500,000 purchase price to the coal deposits. He leases the 500 acres to a tenant farmer on a cash lease arrangement for $70 per acre. John reports his cash rental income and related expenses on Schedule E.

In January 2007, he signed a lease with Black Coal Company for the coal deposits on **100 acres.** The coal company estimates that 80,000 tons of coal will be strip mined from the 100 acres. The terms of the lease provide for the following payments of coal royalties:

- $50 per acre advance royalty on the 100 acres covered by the coal lease, and
- An earned royalty of $10 per ton if and when the coal is extracted (to be reduced by the advance royalty previously paid).

Mining did not begin by the end of 2007. **Therefore, John's only income from the lease in 2007 was the $5,000 advance royalty received upon signing it (100 acres × $50).** He received a 2007 Form 1099-MISC showing this income in Box 2, Royalties.

Question 15A. How should John report the $5,000 advance royalty payment on his 2007 tax return?

Answer 15A. John reports the payment on Form 4797, Part I, as the sale of §1231 property held for more than one year.

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶ Attach to your tax return.▶ See separate instructions.

OMB No. 1545-0184
2007
Attachment Sequence No. **27**

Name(s) shown on return: **John Birge**
Identifying number: **123-23-3434**

1 Enter the gross proceeds from sales or exchanges reported to you for 2007 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions). 1

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

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2	Advance Coal Royalty	03/10/1990	01/17/2007	5,000			5,000

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

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	0
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions).	9	5,000

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

Question 15B. Is John entitled to deduct part of his $100,000 cost basis in the 100 acres covered by the coal lease in column f on the 2007 Form 4797?

Answer 15B. Maybe. Although the 1990 purchase contract was silent regarding the value of the coal deposits on the 500 acres, it is possible that John's tax practitioner could reconstruct a value of the coal on the 100 acres covered by the coal lease. Since John is cash renting the entire 500 acres to a tenant farmer, the 100 acres has obvious income-producing value without any assigned coal deposits value. If a cost basis for the coal is included on the 2007 Form 4797, consultation with a coal valuation expert is recommended.

Assume that $20,000 is a reasonable allocation of the $100,000 purchase price of the 100 acres to the coal deposits. If so, John's basis for computing cost depletion is $20,000. **John basis per ton is 25 cents:**

Total basis in coal	$20,000
Total estimated recoverable tons of coal per Black Coal Company	÷ 80,000
Basis per ton	**$0.25**

The $5,000 advance royalty represents 500 tons at $10 a ton. The amount to report as basis against the advance royalty income is **$125** as shown below.[38]

Number of tons for which payment was received in 2007	500
Basis per ton	× $.25
John's basis	**$125**

> **Note.** Technically, no depletion is allowable if capital gain treatment is taken on coal royalty income under IRC §631(c).[39] However, John may use his cost basis as figured for depletion purposes to determine his **net** capital gain for 2007.

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

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184 — 2007 — Attachment Sequence No. 27

Name(s) shown on return: **John Birge** — Identifying number: **123-23-3434**

1 Enter the gross proceeds from sales or exchanges reported to you for 2007 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1

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

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2	Advance Coal Royalty	03/10/1990	01/17/2007	5,000		125	4,875

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	4,875

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	0
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	4,875

Part II Ordinary Gains and Losses (see instructions)

38. Treas. Reg. §1.612-3(b)(1)

39. Treas. Reg. §1.611-1(b)(2) and IRC §631(c)

Strip mining commences in August 2008. In 2008, Black Coal Company mines 9,500 tons of coal and pays John $90,000 (earned royalties of $95,000 less $5,000 advance royalties paid in 2007).

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Black Coal Company 1 Progress Lane Royalton, IL 62983		1 Rents $ 2 Royalties $ 90000.00	OMB No. 1545-0115 2008 Form 1099-MISC	Miscellaneous Income
		3 Other income $	4 Federal income tax withheld $	Copy B For Recipient
PAYER'S federal identification number 37-7777777	RECIPIENT'S identification number 123-23-3434	5 Fishing boat proceeds $	6 Medical and health care payments $	
RECIPIENT'S name John Birge		7 Nonemployee compensation $	8 Substitute payments in lieu of dividends or interest $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) 140 Oak St.		9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	10 Crop insurance proceeds $	
City, state, and ZIP code Harrisburg, IL 62946		11	12	
Account number (see instructions)		13 Excess golden parachute payments $	14 Gross proceeds paid to an attorney $	
15a Section 409A deferrals $	15b Section 409A income $	16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $

Form 1099-MISC (keep for your records) Department of the Treasury - Internal Revenue Service

Question 15C. How should John report the $90,000 earned royalty payment on his 2008 tax return?

Answer 15C. John will report the 2008 payment in the same way he reported the 2007 advance royalty payment, on his 2008 Form 4797, Part I.

Question 15D. Is John allowed to deduct any cost basis in 2008 to offset the $90,000 royalty income?

Answer 15D. Yes. He can deduct $2,250.

Number of tons for which payment is received in 2008	9,000
Basis per ton	× $0.25
John's basis	**$2,250**

Note. 9,500 tons of coal are mined in 2008. John was already paid for 500 tons via the $5,000 advance royalty he received in 2007. Therefore, John receives the 2008 royalty payments on the remaining 9,000 tons.

For Example 15

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶ **Attach to your tax return.** ▶ **See separate instructions.**

OMB No. 1545-0184
2008
Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
John Birge	123-23-3434

1	Enter the gross proceeds from sales or exchanges reported to you for 2008 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

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

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2	Coal Royalty	03/10/1990	Various	90,000		2,250	87,750

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3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	87,750
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. **Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	0
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	87,750

Part II **Ordinary Gains and Losses** (see instructions)

Note. If the estimated total recoverable tons changes, the basis per ton must be recalculated. Only the remaining cost basis is used to determine the cost per ton when calculated with the new estimates.

Example 16. Use the same facts as **Question 15A and Answer 15A of Example 15,** in which John reports a $5,000 §1231 gain on his 2007 Form 4797. **However, no coal is mined and John receives no earned coal royalty income in 2008 or later years.**

Question 16A. Is John still entitled to capital gain treatment on the $5,000 gain he reported on his 2007 tax return?

Answer 16A. No. The $5,000 reported gain must be recomputed as ordinary income on a 2007 amended return. The authority is Treas. Reg. §1.631-3(c)(2), which states:

However, if the right to mine coal or iron ore under the contract expires, terminates, or is abandoned before the coal or iron ore which had been paid for is mined, the taxpayer shall treat payments attributable to the unmined coal or iron ore as ordinary income and not as received from the sale of coal or iron ore under section 631(c).

Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received. The recomputation shall be made in the form of an amended return where necessary.

Conclusion. Even though the rules for reporting coal royalty income are somewhat difficult to implement, IRC §631(c) represents a significant tax advantage to landowners. The 15% tax rate afforded to net coal royalty income is applicable through 2010 under present law. That low tax rate is an incentive for landowners to enter into coal leases, preferably with an emphasis placed on maximizing advance royalties.

Caution. If the 15% maximum tax rate on capital gains is raised, practitioners should research additional provisions of the Code and Regulations that could be triggered by the increase.

PROBLEM 6: LIMESTONE ROYALTY PAYMENTS

Background Information. Limestone is an important mineral which is used widely throughout the United States. It is mainly used for three purposes:

- As road construction material (often called riprap, crushed and used in roadbeds and parking lots),
- As agricultural lime (usually spread on farmland in the fall), and
- As an aggregate for concrete or asphalt.

In addition, red dolomite limestone is the source of landscaping rock. This type of limestone deposit is uncommon but is found in portions of Minnesota, Wisconsin, and Iowa.

Limestone quarries, which are located throughout the country, pay landowners royalties for the right to extract the mineral. Tax practitioners may have clients who receive Forms 1099-MISC for limestone royalty income.

Example 17. Brent Wilson owns 120 acres of farmland, which he purchased in 2000. He farms 80 tillable acres. A quarry company, which began to extract limestone on the remaining 40 acres in 2006, paid him $80,000 of royalty payments in 2007. He brings you the following documents from the quarry company:

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. **Vermillion Stone Company** **13415 N. 1200 East Road** **Fithian, IL 61844**		1 Rents $ 2 Royalties $ **80000.00**	OMB No. 1545-0115 **2007** Form **1099-MISC**	**Miscellaneous Income**
		3 Other income $	4 Federal income tax withheld $	**Copy B** **For Recipient**
PAYER'S federal identification number **37-1234567**	RECIPIENT'S identification number **888-88-8888**	5 Fishing boat proceeds $	6 Medical and health care payments $	
RECIPIENT'S name **Brent Wilson**		7 Nonemployee compensation $	8 Substitute payments in lieu of dividends or interest $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) **734 Deadbird Lane**		9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	10 Crop insurance proceeds $	
City, state, and ZIP code **Danville, IL 61833**		11	12	
Account number (see instructions)		13 Excess golden parachute payments $	14 Gross proceeds paid to an attorney $	
15a Section 409A deferrals $	15b Section 409A income $	16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $

Form **1099-MISC** (keep for your records) Department of the Treasury - Internal Revenue Service

IMPORTANT INFORMATION — KEEP FOR YOUR 2007 TAX RECORDS

To: All landowners who received limestone royalty payments from Vermillion Stone Company in 2007
From: Vermillion Stone Company
Date: January 31, 2008
Topic: Tax treatment of limestone royalty payments reported to you on the 2007 Form 1099-MISC

According to our records, you received a total of $80,000 of limestone royalty payments in 2007. This total is comprised of:

Payment for limestone used for agricultural lime purposes	**$60,000**
Payment for limestone used for road construction purposes	**20,000**

According to IRS rules and regulations, it is our understanding that you are allowed a percentage depletion rate of 14% for agricultural lime royalties and 5% for road construction royalties.

Please consult your tax advisor for more information on this topic. We suggest you give this information sheet along with the enclosed 2007 Form 1099-MISC to your tax preparer. If you or your tax preparer have questions about this information, please contact our accounting department at: Phone number: (111) 111-1111, extension 345 or Fax Number: (111) 111-2345

Question 17A. Is Brent entitled to percentage depletion on the $80,000 of limestone royalty income?

Answer 17A. Yes. The information provided by the payer is correct. The applicable percentage depletion rates are:

- 14% for the $60,000 of royalties paid for limestone sold for agricultural lime use,[40] and
- 5% for the $20,000 of royalties paid for limestone sold for road construction use.[41]

Question 17B. What is Brent's allowable 2007 percentage depletion amounts?

Answer 17B. He is entitled to the following 2007 depletion deductions:

Category	Royalty Payment	Depletion Rate	Depletion Allowable
Agricultural lime	$60,000	14%	$8,400
Highway construction	20,000	5%	1,000
Total depletion deduction, line 20, Schedule E			**$9,400**

Brent paid the following in 2007 for expenses related to earning the royalty income:

1. Real estate taxes of $3,000 on the 120 acres, allocated as follows:
   - **$1,000** on the 40 acres on which the limestone quarry is located ($3,000 × 40/120 = **$1,000 allocated to Schedule E**), and
   - $2,000 on the 80 tillable acres ($3,000 × 80/120 = $2,000 allocated to Schedule F).

Note. If the real estate tax bill shows different rates for tillable and nontillable acres, it would be better to use the tax bill to determine the allocation instead of calculating it by acre.

2. Legal fees of **$4,000** to defend a noise pollution lawsuit filed by an adjoining homeowner, and
3. Liability insurance premiums of **$2,000** on the quarry operations.

40. IRC §613(b) and Treas. Reg. §1.613-2(a)

41. Ibid.

For Example 17

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

Supplemental Income and Loss

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

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

OMB No. 1545-0074
2007
Attachment Sequence No. 13

Name(s) shown on return: **Brent Wilson**
Your social security number: **888 88 8888**

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

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

Income:		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
3 Rents received	3				3	
4 Royalties received	4	80,000			4	80,000
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-4)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9	2,000				
10 Legal and other professional fees	10	4,000				
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-4)	12				12	
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16	1,000				
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19	7,000			19	7,000
20 Depreciation expense or depletion (see page E-4)	20	9,400			20	9,400
21 Total expenses. Add lines 19 and 20	21	16,400				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-5 to find out if you must file **Form 6198**	22	63,600				
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file **Form 8582.** Real estate professionals must complete line 43 on page 2	23	( )	( )	( )		
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses					24	63,600
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here					25	( )
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2					26	63,600

For Paperwork Reduction Act Notice, see page E-7 of the instructions. Cat. No. 11344L **Schedule E (Form 1040) 2007**

Observations

1. Lines 1 and 2, Schedule E are left blank for royalty property according to the Schedule E instructions.

2. The percentage depletion deduction of $9,400 is limited to 50% of the taxable income from the property figured without the depletion deduction.[42] However, Brent is **not** affected by this limitation. The computation of his 50% of taxable income limitation is:

Royalty income	$80,000
Less: all allowable deductions except depletion	(7,000)
Balance	$73,000
	× 50%
Taxable income limitation for Brent's depletion	$36,500

Brent could use cost depletion if it exceeded the $9,400 of percentage depletion.[43] However, in most cases, percentage depletion will exceed cost depletion for limestone royalties. See IRS Pub. 535, *Business Expenses*, for details regarding cost depletion computation.

3. Any depletion deduction reduces basis. Percentage depletion can still be deducted even after the property's cost basis is reduced to zero.[44] Even so, basis cannot be reduced below zero.[45] Therefore, it is possible for a taxpayer to claim depletion in excess of basis, but upon selling the property, compute gain using zero basis.

4. Depletion can only be claimed by taxpayers who have an economic interest in the income-producing property.[46] Since Brent owns the mineral rights and is receiving income based on the extraction of the limestone, he meets the economic interest test.[47]

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42. IRC §613(a)
43. Ibid.
44. Treas. Reg. §1.611-2(b)(2)
45. Treas. Reg. §1.167(a)-1
46. Treas. Reg. §1.611-1(b)
47. IRS Pub. 535, *Business Expenses*