Chapter 9: Individual Taxpayer Problems

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

PROBLEM 1: ALTERNATIVE MINIMUM TAX UPDATE

BACKGROUND INFORMATION

In her annual report submitted to Congress in early 2007, National Taxpayer Advocate Nina Olson identified the alternative minimum tax as "… the poster-child for tax law complexity…" She noted that although it was originally designed to prevent the wealthy from avoiding tax liability, it now affects large numbers of middle-class taxpayers. She went on to state that "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." This is true because the amount of income subject to AMT was not indexed for inflation.[1]

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Preliminary AMT Statistics for the 2006 Tax Year[2]

The table below compares the impact of AMT on individual tax returns for the 2005[3] and 2006 tax years.

Note. The **preliminary 2006 tax year statistics for AMT** shown in the two charts below are based on a sample of over 243,000 individual returns for tax year 2006 filed between January and late September of 2007. In general, individual returns processed by the IRS after September tend to report disproportionately large amounts of investment income, passive losses, and alternative minimum tax.

Tax Year	Number of Returns Reporting AMT Liability	Amount of AMT Reported
2005	4.005 million	$17.42 billion (actual, not estimated)
2006	4.037 million (0.8% increase)	19.25 billion (10.5% increase)

1. National Taxpayer Advocate's *2006 Annual Report to Congress,* p. 3, www.irs.gov/pub/irs-utl/2006_arc_vol_1_cover__section_1.pdf

2. "Individual Income Tax Returns, Preliminary Data, 2006" IRS Statistics of Income Bulletin, Volume 27, Number 4, Spring 2008, Washington D.C. (2008) http://www.irs.gov/taxstats/article/0,,id=183126,00.html

3. IRS Statistics of Income Bulletin, Volume 27, Number 3, Winter 2008, Washington D.C. (2008), www.irs.gov/newsroom/article/0,,id=179493,00.html

Of the preliminary estimated total of $19.25 billion of AMT reported on 2006 individual tax returns, 98% ($18.85 billion) was paid by taxpayers who reported 2006 AGIs of $100,000 or more. However, as the following table demonstrates, the lowest income taxpayers subject to AMT — those with 2006 AGIs under $15,000 — reported the **highest average AMT** liability.

2006 AGI Range	Number of Returns Reporting AMT	Average Reported AMT Amount
Under $15,000	10,023	$8,146
$15,000 to $29,999	6,117	3,186
$30,000 to $49,999	10,697	2,542
$50,000 to $99,999	219,535	1,241
$100,000 to $199,999	1,132,178	1,892
$200,000 or more	2,658,522	6,285

Preliminary Prior Year Minimum Tax Credit Statistics for the 2006 Tax Year[4]

The table below shows the extent of the prior year minimum tax credit reported on Form 8801, *Credit for Prior Year Minimum Tax*, and claimed on individual tax returns for the 2005 and 2006 tax years.

Tax Year	Number of Returns Claiming the Credit	Amount of Credit Reported
2005	271,909	$1.08 billion
2006	334,017 (22.8% increase)	1.01 billion (6.5% decrease)

Higher 2007 AMT Exemption Amounts

After unprecedented Congressional delay, the Tax Increase Prevention Act of 2007 (TIPA) was signed by President Bush on December 26, 2007. It provided a temporary AMT "patch" for 2007. The **2007 AMT exemptions amounts** were raised to:

Married filing jointly or qualifying widow(er)	$66,250
Single or head of household	44,350
Married filing separately	33,125

Personal Tax Credits Allowed Against Both 2007 Regular and AMT Liability

As expected, TIPA extended prior law by allowing most personal nonrefundable credits to offset both 2007 regular and AMT liability. **Therefore, in 2007 individual taxpayers continued to receive full benefit of the child tax credit and the personal tax credits reported on the following forms:**

- Form 2441, *Child and Dependent Care Expenses*
- Form 1040, Schedule R, *Credit for the Elderly or the Disabled*
- Form 8901, *Information on Qualifying Children Who Are Not Dependents*
- Form 8863, *Education Credits (Hope and Lifetime Learning)*
- Form 8839, *Qualified Adoption Expenses*

4. "Individual Income Tax Returns, Preliminary Data, 2006" IRS Statistics of Income Bulletin, Volume 27, Number 4, Spring 2008, Washington D.C. (2008) http://www.irs.gov/taxstats/article/0,,id=183126,00.html

- Form 8880, *Credit for Qualified Retirement Savings Contributions*
- Form 8396, *Mortgage Interest Credit*
- Form 5695, *Residential Energy Credits*
- Form 8859, *District of Columbia First-Time Homebuyer Credit*

Note. The tax credit for new qualified hybrid vehicles was not allowed against 2007 AMT liability. It is anticipated that 2008 legislation will retain this provision. If so, individual taxpayers with 2008 AMT liability will lose part or all of their otherwise allowable 2008 hybrid vehicle tax credit.

2008 AMT Exemption Amounts

It is anticipated that Congress will pass legislation that either:

- Extends the 2007 AMT exemption amounts to 2008 (see chart above), or
- Increases the 2008 AMT exemption amounts.

H.R. Bill 5031, introduced in January 2008, would raise the 2008 AMT exemption amounts to:

Married filing jointly or qualifying widow(er)	$69,950
Single or head of household	46,200
Married filing separately	34,975

AMT REFUNDABLE CREDIT

Background Information

The Tax Relief and Health Care Act of 2006 (TRHCA) provided a new refundable credit beginning in 2007 for a **long-term unused minimum tax credit** that was carried forward to 2007 from 2003 or earlier. This new credit is referred to as the **AMT refundable credit.**[5]

The AMT refundable credit is based on the portion of the minimum tax credit that 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 **2008** returns, a long-term unused minimum tax credit is one that was carried forward from **2004 or earlier years** to 2008.

The credit is computed on Form 8801, *Credit for Prior Year Minimum Tax.* Only **deferral items,** such as the phantom income from exercise of incentive stock options, accelerated depreciation, and gain or loss on property sales can create a minimum tax credit. **Exclusion items such as personal exemptions, the standard deduction, and Schedule A taxes, can never generate a minimum tax credit.**

Note. This credit is of significant benefit to the taxpayers who paid AMT on the exercise of incentive stock options (ISOs) on their 2004 or earlier tax returns. Many taxpayers had substantial AMT liability created by phantom income from their ISO exercises. In numerous instances, the value of the IS0-acquired stock plummeted leaving the taxpayers with huge AMT liability and no cash flow with which to pay the AMT.

TRHCA used an incorrect formula to calculate the amount of the AMT refundable credit for tax years after 2007. The formula was revised by the Technical Corrections Act of 2007 (TCA). The result of the revision is that taxpayers will be able to claim a larger refundable AMT credit on their 2008–2012 returns.

5. IRC §53(e)(2)(A)

Revised Formula for Computing the AMT Refundable Credit

The credit is equal to the **greater** of:

- $5,000;
- 20% of the long-term unused minimum tax credit; or
- The AMT refundable credit amount (if any) for the prior tax year.[6]

However, the credit cannot exceed the amount of unused credit carried forward.

Example 1. Brian exercised an ISO in 2004 and still owns the stock. He paid $7,000 of AMT on his 2004 tax return due to creation of phantom AMT income. He claimed no minimum tax credits on his 2005 and 2006 return. He claimed a $3,000 minimum tax credit on his 2007 return. His minimum tax credit carryforward to 2008 is $4,000.

Note. Brian's 2007 minimum tax credit of $3,000 was **not** an AMT refundable credit. The $7,000 of AMT he paid in 2004 does not become a long-term unused minimum tax credit eligible for the AMT refundable credit provisions until 2008.

Tax Result for Example 1. Under the revised AMT refundable credit formula, Brian is entitled to claim a 2008 AMT refundable credit of $4,000. The credit is reported on Form 8801, *Credit for Prior Year Minimum Tax.* A blank Form 8801 is shown following this example.

Observation for Example 1. Using the revised formula, Brian's 2008 AMT refundable credit amount is the **greater** of:

- $5,000;
- $800 (20% of his $4,000 long-term unused minimum tax credit for 2008); or
- $0 (the amount of Brian's AMT refundable credit for 2007).

The highest of the 3 choices is $5,000. However, the refundable credit is limited to his remaining carryforward of $4,000.

6. IRC §53(e)(2)(A) after amendment by TCA

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 | Identifying number

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	

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	
17	Enter the amount from line 15 above	17	
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	
19	**2006 minimum tax credit carryforward.** Enter the amount from your 2006 Form 8801, line 26	19	
20	Enter your 2006 unallowed qualified electric vehicle credit (see instructions)	20	
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	
22	Enter your 2007 regular income tax liability minus allowable credits (see instructions)	22	
23	Enter the amount from your 2007 Form 6251, line 33, or 2007 Form 1041, Schedule I, line 54	23	
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	
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	
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	
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	
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	

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

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Part III Tax Computation Using Maximum Capital Gains Rates

Caution. If you did not complete the 2006 Qualified Dividends and Capital Gain Tax Worksheet, the 2006 Schedule D Tax Worksheet, or Part V of the 2006 Schedule D (Form 1041), see the instructions before completing this part.

29 Enter the amount from Form 8801, line 10 . . . 29

30 Enter the amount from line 6 of your 2006 Qualified Dividends and Capital Gain Tax Worksheet, the amount from line 13 of your 2006 Schedule D Tax Worksheet, or the amount from line 22 of the 2006 Schedule D (Form 1041), whichever applies* . . . 30

If you figured your 2006 tax using the 2006 Qualified Dividends and Capital Gain Tax Worksheet, skip line 31 and enter the amount from line 30 on line 32. Otherwise, go to line 31.

31 Enter the amount from line 19 of your 2006 Schedule D (Form 1040), or line 14b, column (2), of the 2006 Schedule D (Form 1041) . . . 31

32 Add lines 30 and 31, and enter the **smaller** of that result or the amount from line 10 of your 2006 Schedule D Tax Worksheet . . . 32

33 Enter the **smaller** of line 29 or line 32 . . . 33

34 Subtract line 33 from line 29 . . . 34

35 If line 34 is $175,000 or less ($87,500 or less if married filing separately for 2006), multiply line 34 by 26% (.26). Otherwise, multiply line 34 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately for 2006) from the result . . . ▶ 35

36 Enter:
- $61,300 if married filing jointly or qualifying widow(er) for 2006,
- $30,650 if single or married filing separately for 2006,
- $41,050 if head of household for 2006, or
- $2,050 for an estate or trust . . . 36

37 Enter the amount from line 7 of your 2006 Qualified Dividends and Capital Gain Tax Worksheet, the amount from line 14 of your 2006 Schedule D Tax Worksheet, or the amount from line 23 of the 2006 Schedule D (Form 1041), whichever applies. If you did not complete either worksheet or Part V of the 2006 Schedule D (Form 1041), enter -0- . . . 37

38 Subtract line 37 from line 36. If zero or less, enter -0- . . . 38

39 Enter the **smaller** of line 29 or line 30 . . . 39

40 Enter the **smaller** of line 38 or line 39 . . . 40

41 Multiply line 40 by 5% (.05) . . . ▶ 41

42 Subtract line 40 from line 39 . . . 42

43 Multiply line 42 by 15% (.15) . . . ▶ 43

If line 31 is zero or blank, skip lines 44 and 45 and go to line 46. Otherwise, go to line 44.

44 Subtract line 39 from line 33 . . . 44

45 Multiply line 44 by 25% (.25) . . . ▶ 45

46 Add lines 35, 41, 43, and 45 . . . 46

47 If line 29 is $175,000 or less ($87,500 or less if married filing separately for 2006), multiply line 29 by 26% (.26). Otherwise, multiply line 29 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately for 2006) from the result . . . 47

48 Enter the **smaller** of line 46 or line 47 here and on line 11. (If you filed Form 2555 or 2555-EZ for 2006, see page 4 of the instructions) . . . 48

* The 2006 Qualified Dividends and Capital Gain Tax Worksheet is on page 38 of the 2006 Instructions for Form 1040. The 2006 Schedule D Tax Worksheet is on page D-10 of the 2006 Instructions for Schedule D (Form 1040) (page 38 of the 2006 Instructions for Form 1041).

Part IV Tentative Refundable Credit

49 Enter the amount from line 21		**49**	
50 Enter the total of lines 18 and 20 from your 2005 Form 8801. If zero or less, enter -0-	**50**		
51 Enter the total of lines 18 and 20 from your 2006 Form 8801. If zero or less, enter -0-	**51**		
52 Enter the total of lines 18 and 20 from your 2007 Form 8801. If zero or less, enter -0-	**52**		
53 Add lines 50 through 52		**53**	
54 **Long-term unused minimum tax credit.** Subtract line 53 from line 49 (If zero or less, **stop;** enter -0- on line 26. **Do not** complete the rest of Part IV)		**54**	
55 If line 54 is: ● Less than $5,000, enter the amount from line 54 ● At least $5,000, but not more than $25,000, enter $5,000 ● More than $25,000, multiply line 54 by 20% (.20)		**55**	
56 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 the instructions for the amount to enter)	**56**		
57 Is line 56 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 55 above on line 26. **Do not** complete the rest of Part IV. ☐ **Yes.** Enter the amount shown above for your filing status	**57**		
58 Subtract line 57 from line 56	**58**		
59 Is line 58 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 58 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)	**59**		
60 Multiply line 59 by 2% (.02) and enter the result as a decimal (rounded to at least three places)		**60**	.
61 Multiply line 55 by line 60		**61**	
62 Subtract line 61 from line 55. Enter the result here and on line 26		**62**	

Form **8801** (2007)

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Following is an example that explains in greater detail the clarification made by TCA.

Note. Example 2 involves 2003 AMT liability that was carried over as a credit to tax years 2004, 2005, 2006, and 2007. The unused AMT credit of $65,000 was reported on the 2007 Form 8801. The taxpayers received a 2007 credit for 20% of the unused $65,000 credit. Due to the clarification, they are entitled to the remaining unused credit ratably over the four-year period 2008–2011.

Example 2. Harry exercised an incentive stock option in 2003 and retained the stock. This was not a cashless exercise like most employees utilize. The 2003 joint return of Harry and his wife, Carrie, reported the following:

Regular 2003 tax	$ 5,000
2003 AMT due to phantom income from the ISO exercise	80,000
Total 2003 tax	$85,000

Their joint returns for 2004, 2005, and 2006 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**

The amount of their **long-term unused minimum tax credit** carried forward to 2007 was **$65,000** ($80,000 carried forward minimum tax credit – $15,000 total minimum tax credits used). Harry and Carrie used a $5,000 minimum credit each year for three years to offset their regular tax liability.[7]

The amount of their 2007 **AMT refundable credit** from their 2007 Form 8801 (not shown) was **$13,000.** Their AMT refundable credit is 20% of their long-term unused minimum tax credit carried forward to 2007 ($65,000 × 20% = $13,000).[8]

Tax Result for Example 2. The clarification made by the TCA is that Harry and Carrie are entitled to an identical AMT refundable credit of $13,000 on their 2008, 2009, 2010, and 2011 returns. Therefore, they will have no long-term unused minimum tax credit remaining after 2011.

This result assumes the following:

- Harry and Carrie are **not subject to the phaseout rules** for the AMT refundable credit for the years 2008 through 2011.

Note. See observation 3 following for the AGI phaseout ranges for 2008.

- They have **no tentative minimum tax** (Form 6251, line 33) for the years 2008–2011.

7. IRC §53(e)(3)(A)

8. IRC §53(e)(2)(A)

TAX PLANNING OBSERVATIONS FOR 2008

1. The AMT refundable credit provision[9] is applicable for tax years beginning after 2006 and before January 1, 2013. This provision applies only for 2007 through 2012 individual tax returns unless it is extended by future legislation.

2. For 2008 Forms 1040, the definition of a long-term unused minimum tax credit is one that was carried over from **2004 or earlier years** to 2008.[10]

3. The phaseout for high-income taxpayers has resulted in planning dilemmas for these taxpayers. They may have paid extremely large AMT liabilities resulting from their exercise of an ISO in 2004 or earlier tax years. However, if their 2008 through 2011 AGIs are too high, their otherwise potentially large refundable AMT credit for those years may be reduced or eliminated.

   Some taxpayers in this situation may decide to quit working or work part time in 2008 through 2011 in order to qualify for a large nontaxable refundable AMT credit. Taxpayers whose **2008 AGIs** are in the phaseout range shown in the chart below[11] may benefit from tax planning that attempts to lower 2008 AGI in order to qualify for the refundable AMT credit.

Filing Status	AGI That Reduces Credit	AGI That Eliminates Credit
Single	$159,950	$282,450
Married filing jointly	239,950	362,450
Qualifying widow(er)	239,950	362,450
Head of household	199,950	322,450
Married filing separately	119,975	181,225

Note. The AMT credit phaseout ranges are the same phaseout ranges as the deduction for personal exemptions.[12]

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PROBLEM 2: DEPENDENCY EXEMPTION RULES FOR UNRELATED CHILD

BACKGROUND INFORMATION

The Working Families Tax Relief Act of 2004 (WFTRA) added the terms qualifying child and qualifying relative to IRC §152. WFTRA established a uniform definition of a **qualifying child** under §152(c) for determining whether a taxpayer may claim the following child-related tax benefits:

- Head of household filing status
- Earned income credit
- Child tax credit
- Child and dependent care credit
- Dependency exemption deduction

9. IRC §53 as added by the Tax Relief and Health Care Act of 2006
10. IRC §53(e)(3)(A)
11. Rev. Proc. 2007-66, IRB 2007-45
12. IRC §53(e)(2)(B)

WFTRA also established the term **qualifying relative** to identify individuals (other than a qualifying child) for whom a dependency exemption may be claimed. Due to numerous inquiries from tax professionals, the IRS issued the following clarifications regarding claiming the dependency exemption deduction for an unrelated child:

- Notice 2008-5[13]
- Internal Legal Memorandum 200812024, February 8, 2008

A **qualifying relative** must meet the following tests under IRC §152(d) in order to entitle the taxpayer to a dependency exemption deduction for that individual. The qualifying relative must:

1. Bear a certain relationship to the taxpayer;[14]
2. Have gross income for the tax year that is less than the exemption amount ($3,500 for 2008);[15]
3. Derive over half his support for the tax year from the taxpayer;[16] and
4. Not be a qualifying child of the taxpayer or of **any other taxpayer** for the tax year.[17]

A qualifying relative may include an individual who has the same principal place of residence as the taxpayer and who is a member of the taxpayer's household for the entire year.[18] A person meeting this definition does **not have to be related** in any other manner to the taxpayer. However, this type of qualifying relative will **not** qualify a taxpayer for the head of household filing status,[19] earned income credit,[20] or the child tax credit.[21]

The fourth requirement above created some confusion in situations in which a taxpayer supported a child who was not his qualifying child, but the child was a qualifying child for another member of the household. Notice 2008-5 clarifies the definition of "any other taxpayer."

CLARIFICATIONS FOR AN UNRELATED CHILD

The following requirements must be met in order to claim the dependency exemption for an **unrelated child who is also a qualifying child of another person:**

1. The child's parent (or other person for whom the child is defined as a qualifying child) is not required by IRC §6012[22] to file an income tax return for the tax year, **and**
2. Does not file an income tax return for the tax year, **or**
3. Files an income tax return solely to obtain a refund of withheld income taxes.

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13. Notice 2008-5, IRB 2008-2, p. 256, Jan. 14, 2008
14. IRC §152(d)(1)(A)
15. IRC §152(d)(1)(B)
16. IRC §152(d)(1)(C)
17. IRC §152(d)(1)(D)
18. IRC §152(d)(1)(H)
19. IRC §2(b)(3)
20. IRC §32(c)(1)
21. IRC §24(a)
22. IRC §6012 defines the general requirements for who is required to file income tax returns.

Example 3. Chet's girlfriend, Cindy, and her 5-year-old son, Kurt, live together **all of 2008** in Chet's rented home. Cindy, age 26, has no gross income in 2008 and does not file a 2008 tax return. Chet, age 27, provided more than half of both Cindy's and Kurt's support during 2008. Kurt's father paid only $300 of child support to Cindy for Kurt's support during the year. Neither Cindy nor Kurt received any public assistance or food stamps in 2008.

Tax Result for Example 3. Both Cindy and Kurt are Chet's qualifying relatives for 2008. Kurt is also Cindy's qualifying child. However, Chet may claim a dependency exemption for Kurt, because Cindy is not required to file and does not file a tax return for 2008. Chet may also claim Cindy's dependency exemption provided that her cohabitation with him is not illegal under local law.

Note. If Cindy and Kurt initially moved into Chet's home in August 2008, neither Cindy nor Kurt would qualify as his qualifying relative because they did not live in Chet's household for the **entire year.** Consequently, Chet would not be entitled to claim a 2008 dependency exemption for either of them.

Chet must use the **single filing status** for 2008, and he **cannot claim any earned income credit or child tax credit** for Kurt. He also cannot claim any child or dependent care credit for Kurt on Form 2441 unless Kurt is physically or mentally disabled. If Chet's income is low enough, he may claim the earned income credit for taxpayers with no qualifying children.

Example 4. Use the same facts as **Example 3,** except Cindy has 2008 W-2 wages of $1,500 and $100 of income tax was withheld. She is not required to file a 2008 tax return. With one qualifying child, Cindy is entitled to claim $519 of earned income credit for Kurt. With no qualifying children, Cindy could receive $117 of earned income credit based on her wages. Cindy files her 2008 return using a single filing status **solely to obtain a $100 refund of withheld income tax** and does **not** claim **any** earned income credit.

Tax Result for Example 4. Both Cindy and Kurt are Chet's qualifying relatives for 2008. Even though Kurt is Cindy's qualifying child and she did file a tax return, Cindy is not considered "any other taxpayer" because she only filed a return to claim a refund of her $100 withholding. Chet may claim a dependency exemption for Kurt. He may also claim Cindy's dependency exemption provided her cohabitation with him is not illegal under local law.

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Chet must use the **single filing status** for 2008, and he **cannot claim any earned income credit or the child tax credit** for Kurt. Nor can he claim any child or dependent care credit for Kurt on Form 2441 unless Kurt is physically or mentally incapable. If Chet's income is low enough, he may claim the earned income credit for taxpayers with no qualifying children.

Note. In **Example 4**, Cindy's 2008 gross income is less than the $3,500 exemption amount.

Example 5. Use the same facts as **Example 3,** except Cindy has 2008 W-2 wages of $8,000 and $700 of income tax was withheld. Her gross income is below the 2008 filing threshold. With one qualifying child, Cindy is entitled to claim $2,729 of earned income credit for Kurt. Cindy files her 2008 single return to **obtain her $700 of withheld income taxes** and **claims the earned income credit for Kurt.**

Tax Result for Example 5. Because Cindy claimed the earned income credit, she is considered a "taxpayer." Therefore, Kurt is not Chet's qualifying relative in 2008, and Chet is not entitled to claim Kurt's dependency exemption. Cindy is **not** Chet's qualifying relative in 2008 because her gross income exceeds $3,500. Consequently, he may not claim Cindy's dependency exemption. Chet must use the single filing status for 2008.

Effective Date of Notice 2008-5. The clarifications explained in the notice are effective for tax years beginning **after 2004.** As a result, amended returns may be filed for 2005, 2006, and 2007 returns to take advantage of the liberalized rules for claiming dependency exemptions for an unrelated child.

Note. See pages 31–46 in the 2006 *University of Illinois Federal Tax Workbook* for a comprehensive review of the qualifying relatives and uniform definition of a child rules that became effective in 2005. The tax result for Scenario 4, Bubba and Charlene, in the Factual Scenarios on page 41 of the 2006 book is changed by Notice 2008-5. This scenario is similar to **Example 4.** Please note that the scenario mistakenly indicates that Bubba and Charlene live together in a common-law marriage. This was corrected to say that their relationship is **not** recognized as a common-law marriage.

PROBLEM 3: KIDDIE TAX UPDATE (FORM 8615)

HISTORICAL BACKGROUND

The kiddie tax provisions, which initially applied to 1989 individual tax returns, affected only the unearned income of children under age 14. Beginning with 2006 tax returns, the age limit was increased to include children under 18.[23] The following table shows the impact of this age change for 2006.[24]

Tax Year	Number of Children Filing Form 8615	Kiddie Tax Paid
2005	142,000 (rounded)	$311.24 million
2006	331,000 (rounded)	645.20 million (107.3% increase)

EXPANDED RULES FOR 2008 (AND LATER TAX YEARS)

The Small Business and Work Opportunity Tax Act of 2007 expanded the kiddie tax provisions again. Starting in 2008, these provisions apply to children who are:

- Under 18
- 18 years old, unless the child's earned income exceeds 50% of her total support for 2008, **and**
- Full-time students who are older than 18 but younger than 24 on December 31, 2008, **unless** the student's **earned income** exceeds 50% of his total support for 2008.[25]

Special Rule for Children Who Reach Age 19 on January 1, 2009. The expanded kiddie tax rules for 2008 do **not** apply to a child who was born on January 1, 1990. A favorable IRS ruling treats such children as having reached age 19 on December 31, 2008.[26]

Note. The earned income support test exception will not be met by the majority of full-time students. If the exception is not met, the expanded kiddie tax provisions apply to the 2008 and later year tax returns of the student.

23. IRC §1(g)(2), as amended by the Tax Increase Prevention and Reconciliation Act of 2005

24. Preliminary Data for 2006 Returns, "Winter 2007-2008 Statistics of Income Bulletin," IRS News Rel. IR-2008-27 (Feb. 28, 2008)

25. IRC §1(g)(2)(A)

26. IRS Pub. 929, *Tax Rules for Children and Dependents*

There are three other conditions which must be met before the expanded kiddie tax rules apply for 2008 (and later tax years):

- The 2008 **unearned** income of the child must exceed $1,800 (indexed for inflation),
- The child has at least one living parent as of the end of the year, and
- The child does not file a joint return for the year.

Note. The kiddie tax rules apply regardless of whether the child is claimed as a dependent by the parent(s) or someone else. They also apply even when a child's exemption is phased out on the parent(s)' return.

TAXATION OF CHILD'S UNEARNED INCOME IN 2008

For 2008 tax returns, the **unearned income** above $1,800 of children subject to the kiddie tax is taxed at the parent's highest marginal rate.

Example 6. Sydney is a full-time single graduate student at the University of Illinois during 2008. She celebrated her 23rd birthday on August 10, 2008. Her 2008 tax return reports the following:

Wages from a part-time job	$ 5,000
Interest income	2,000
Qualified dividends from Ameren stock gifted by her grandparents	3,000
Sydney's 2008 AGI	**$10,000**
Less: standard deduction ($5,000 wages + $300)	(5,300)
Less: exemption (not applicable; claimed by parents)	(0)
Sydney's 2008 taxable income	**$ 4,700**

Her total support for 2008 is $23,000, including the graduate student tuition, fees, books, and housing expenses paid by her parents. It does not include the value of a partial-tuition scholarship she received from the University of Illinois. The only support Sydney provided from her own funds during 2008 was $4,500, the amount of her take-home pay from her wages. **Therefore, Sydney did not provide over half of her own support from her earned income.**

Note. The $500 of federal and state income taxes and social security and Medicare taxes withheld from Sydney's wages is not included in her total support figure of $23,000.[27]

Tax Result for Example 6. The expanded kiddie tax rules apply to Sydney. Her parents claim her exemption on their joint 2008 return. Their 2008 tax return must be prepared first. Then Sydney's 2008 tax return can be prepared with an attached Form 8615. (The tax calculation shown on Sydney's 2008 Form 8615 assumes an AMT patch is passed for 2008 returns.)

Note. Sydney's parents cannot elect to report her $5,000 of interest and dividends on their 2008 joint return because Sydney had wage income. See the information below in the **Parent(s)' Election to Report Child's Interest and Dividends** section.

27. IRS Pub. 501, *Exemptions, Standard Deduction, and Filing Information*

For Example 6

Form **8615** | **Tax for Certain Children Who Have Investment Income of More Than $1,800** | OMB No. 1545-0074 **2008**

Department of the Treasury Internal Revenue Service (99)

▶ Attach only to the child's Form 1040, Form 1040A, or Form 1040NR.
▶ See separate instructions.

Attachment Sequence No. 33

Child's name shown on return	Child's social security number
Sydney Zambrano	123 45 6789

Before you begin: If the child, the parent, or any of the parent's other children for whom Form 8615 must be filed must use the Schedule D Tax Worksheet or has income from farming or fishing, see **Pub. 929,** Tax Rules for Children and Dependents. It explains how to figure the child's tax using the **Schedule D Tax Worksheet** or **Schedule J** (Form 1040).

A Parent's name (first, initial, and last). **Caution:** *See instructions before completing.*	B Parent's social security number
Alfonso Zambrano	222 22 2222

C Parent's filing status (check one):
☐ Single ☑ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Part I Child's Net Investment Income

1	Enter the child's investment income (see instructions)	1	5,000
2	If the child **did not** itemize deductions on **Schedule A** (Form 1040 or Form 1040NR), enter $1,800. Otherwise, see instructions	2	1,800
3	Subtract line 2 from line 1. If zero or less, **stop;** do not complete the rest of this form but **do** attach it to the child's return	3	3,200
4	Enter the child's **taxable income** from Form 1040, line 43; Form 1040A, line 27; or Form 1040NR, line 40. If the child files Form 2555 or 2555-EZ, see the instructions	4	4,700
5	Enter the **smaller** of line 3 or line 4. If zero, **stop;** do not complete the rest of this form but **do** attach it to the child's return	5	3,200

Part II Tentative Tax Based on the Tax Rate of the Parent

6	Enter the parent's **taxable income** from Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 40; or Form 1040NR-EZ, line 14. If zero or less, enter -0-. If the parent files Form 2555 or 2555-EZ, see the instructions	6	99,575
7	Enter the total, if any, from Forms 8615, line 5, of **all other** children of the parent named above. **Do not** include the amount from line 5 above	7	0
8	Add lines 5, 6, and 7 (see instructions)	8	102,775
9	Enter the tax on the amount on line 8 based on the **parent's** filing status above (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☑	9	18,189
10	Enter the parent's tax from Form 1040, line 44; Form 1040A, line 28, minus any alternative minimum tax; Form 1040EZ, line 11; Form 1040NR, line 41; or Form 1040NR-EZ, line 15. **Do not** include any tax from **Form 4972** or **8814** or any tax from recapture of an education credit. If the parent files Form 2555 or 2555-EZ, see the instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) was used to figure the tax, check here ▶ ☐	10	17,581
11	Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to **Part III**	11	608
12a	Add lines 5 and 7 — 12a: 3,200		
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places)	12b	× 1. 000
13	Multiply line 11 by line 12b	13	608

Part III Child's Tax—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14	Subtract line 5 from line 4 — 14: 1,500		
15	Enter the tax on the amount on line 14 based on the **child's** filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☑	15	41
16	Add lines 13 and 15	16	649
17	Enter the tax on the amount on line 4 based on the **child's** filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☑	17	171
18	Enter the **larger** of line 16 or line 17 here and on the **child's** Form 1040, line 44; Form 1040A, line 28; or Form 1040NR, line 41. If the child files Form 2555 or 2555-EZ, see the instructions	18	649

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 64113U Form **8615** (2008)

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Observations for Example 6

1. Sydney's total 2008 tax is $649 (Form 8615, line 18). Without applying the kiddie tax rules, her 2008 total tax would have been only $171 (Form 8615, line 17).
2. Sydney's parents' top marginal tax rate for 2008 is 25%. A portion of her qualified dividends is allocated to the parents' income and taxed at 15%. (The instructions for Form 8615 provide the allocation formula.)
3. The amount of Sydney's investment income taxed at her parents' rate is $3,200 (Form 8615, line 5).
4. Sydney will not be penalized by the kiddie tax rules for 2009 when she reaches age 24.

Example 7. Luella received her undergraduate degree from Indiana University in May 2008. She is 22 years old as of December 31, 2008. She began full-time employment as a nurse on June 1, 2008, and earned $30,000 of 2008 wages. She provided over half of her own support for 2008 from her take-home pay.

Tax Result for Example 7. Even though Luella has $7,000 of investment income in 2008, she is exempt from the kiddie tax rules because she meets the earned income exception.

> **Note.** Luella's parents cannot claim her exemption on their joint 2008 tax return.

PARENT(S)' ELECTION TO REPORT CHILD'S INTEREST AND DIVIDENDS[28]

Instead of filing a separate return for the child, the parent may elect to report a child's interest and dividend income (including capital gain distributions) on his return. The parent makes the election by completing Form 8814, *Parents' Election to Report Child's Interest and Dividends*, and attaching it to the parent's 2008 Form 1040. A separate Form 8814 is required for each child for whom the election is made. This election can be made for one or more children.

This election can be made provided all the following conditions are met:

1. The child is subject to the kiddie tax rules.
2. The child only had income from interest and dividends (including capital gain distributions).
3. The **2008** interest and dividend income was more than $900 but less than $9,000.[29]
4. The child is required to file a return unless the parent(s) makes the election on Form 8814.
5. The child does not file a joint return.
6. No estimated tax payment was made for the current year and no prior year overpayment was applied to the current year's taxes under the child's name and social security number.
7. No federal income tax was withheld from the child's interest and dividend income under the backup withholding rules.
8. If the child's parents do not file a joint return together, the parent making the election must be the parent whose tax return would be required to be used to figure the child's tax on the child's return absent the election.

> **Note.** If this election is made by the parent, the child is not required to file a 2008 tax return. However, this small benefit is usually outweighed by the effect of the election on the parent's tax. Including the child's income on the parent's return raises the parent's AGI, which affects a host of provisions that are subject to AGI-based limitations.

28. IRS Pub. 929, *Tax Rules for Children and Dependents*

29. Rev. Proc. 2007-66, IRB 2007-45

9

IMPACT ON FAMILY TAX PLANNING

The expanded kiddie tax rules that apply for 2008 and later years make prior family tax-planning strategies obsolete. The pre-2008 planning strategy involved parents (or grandparents) transferring assets such as appreciated stock to their children (or grandchildren).

This planning anticipated that the children would sell the gifted appreciated assets and take advantage of the zero rate on net capital gains and qualified dividends for tax years 2008 through 2010. Using that now-outdated strategy, children whose top tax bracket for 2008, 2009, and 2010 was 15% could sell the gifted assets and pay no tax on the long-term capital gain realized in those three years.

If the parent(s) (or grandparents) had not gifted the assets and sold them in 2008, 2009, or 2010, their tax rate on the long-term capital gain would be 15% under current tax law.

Tax Planning Tips for 2008 and Later Years

Following are several investment-related planning ideas for parents (or grandparents) to consider. These planning tips apply for children (or grandchildren) who will be subject to the expanded kiddie tax rules.

1. Consider buying the following property in the name of the child. It might appreciate and will produce little or no investment income.
   - Vacant land
   - Growth stocks or mutual funds (which usually pay fewer dividends)
   - Municipal tax-exempt bonds
2. Consider U.S. savings bonds for the child. The reporting of the interest can be deferred until the bonds are sold, preferably after the child is immune from the kiddie tax rules.
3. Consider buying education bonds. Interest on Series EE and I bonds purchased in the parent's name and used to pay qualified education expenses are exempt from taxation. Thus, redemption of the bonds may be tax-free assuming all of the conditions are met.

> **Note.** See Chapter 6, "Education Tax Incentives," for information on the tax-free use of Series EE savings bonds for qualified higher education expenses.

4. Consider employing a child in the family business. Only a child's unearned income is subject to the kiddie tax rules. As a bonus, the child would then be eligible to contribute to a traditional or Roth IRA.
5. Section 529 qualified tuition programs are even more attractive under the expanded kiddie tax rules. Distributions from Section 529 plans are tax free if used for qualified college expenses. Thus, the distributions completely avoid the kiddie tax issue.

PROBLEM 4: ZERO TAX RATE ON NET CAPITAL GAINS AND QUALIFIED DIVIDENDS

BACKGROUND INFORMATION[30]

The unprecedented zero tax rate that applies to net capital gains and qualified dividends takes effect in 2008. Although the zero tax rate under current law applies for 2008 through 2010,[31] many professionals in the tax field have commented on the distinct possibility that **future legislation could rescind or amend this taxpayer-friendly provision after 2008, a presidential election year.**

Status of the Zero Tax Rate for 2011 and Future Tax Years

If current law is not extended beyond 2010, the tax rate on **post-2010 net capital gains** reverts to:

- 10% for those taxpayers in the 10% and 15% tax brackets (8% if a more than 5-year holding period is met for the capital asset sold), and
- 20% for those taxpayers whose regular tax rate exceeds 15% (18% if a more than 5-year holding period is met for the capital asset sold).

In addition, **post-2010 qualified dividend income** loses its tax-favored status and will be taxed as ordinary income at the applicable tax rate depending on a taxpayer's taxable income.

> **Note.** The current tax rates on the ordinary taxable income of individuals are 10%, 15%, 25%, 28%, 33%, and 35%. However, under current law, these rates are scheduled to revert to the pre-2001 tax rates of 15%, 28%, 31%, 36%, and 39.6% after 2010.

WHEN THE ZERO TAX RATE BENEFITS TAXPAYERS

The zero tax rate may benefit taxpayers who have a net capital gain and/or qualified dividends. **The combination of net capital gains and/or qualified dividends is referred to as "adjusted net capital gain" (ANCG).**[32]

> **Note.** The term "net capital gain" means net long-term capital gains less net short-term capital losses. The zero tax rate does not apply to gains on collectibles,[33] certain small business stock,[34] the depreciation portion of §1245 gains,[35] and unrecaptured §1250 gain on the sale of real estate.[36] However, when used in this chapter, **the term "net capital gain" will include only capital gains that are qualified for the zero tax rate.**

When the Zero Tax Rate Applies

If a taxpayer's taxable income less the amount of ANCG is equal to or less than the ceiling for the 15% tax bracket, the zero tax rate applies. This calculation is expressed in the following formula.

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30. *"Planning for the 2008-2010 Zero-Percent Adjusted Net Capital Gain Rate"* by Alan R. Sumutka, Andrew M. Sumutka, and Gina S. Margarido, The CPA Journal (A Publication of the New York State Society of CPAs), December 2006 www.nysscpa.org/cpajournal/2006/1206/essentials/p40.htm
31. Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)
32. IRC §1(h)(1)(C)
33. IRC §1(h)(5)
34. IRC §1202
35. IRC §1245(a)(1)
36. IRC §1(h)(1)(D)

Calculation to Determine Whether a Taxpayer Can Benefit from the Zero Tax Rate:

Step 1. Calculate other taxable income.

1. Taxable income reported on return (2008 Form 1040, line 43)	$XXXXXX
2. Less: amount of ANCG (net capital gain + qualified dividend income)	(XXXXXX)
3. Other taxable income	$XXXXXX

Step 2. Compare line 3 in Step 1 to the ceiling for the taxpayer's 15% tax bracket, which for 2008 is:

Filing Status	2008 15% Tax Bracket Ceiling
Married filing jointly and qualifying widow(er)	$65,100
Single and married filing separately	32,550
Head of household	43,650

Step 3. If the other taxable income (Step 1, line 3) does **not exceed** the Step 2 amount, the taxpayer benefits from the zero tax rate.

Note. Qualified dividend income excludes dividends treated as investment income on Form 4952 in determining the investment interest expense deduction.

Example 8. Jack and Mavis file a joint 2008 return which reports the following:

Wages	$110,000
Long-term gain on sale of inherited Coca-Cola stock	120,000
2008 AGI	**$230,000**
Less: exemption (5 × $3,500 not limited by AGI)	(17,500)
Less: allowable itemized deductions after 3% AGI reduction	(44,000)
2008 taxable income	**$168,500**

Using the formula, their **other taxable income** is $48,500:

Reported taxable income	$168,500
Less: ANCG (long-term gain on stock sale)	(120,000)
Other taxable income	**$ 48,500**

Tax Result for Example 8. Because $48,500 is less than $65,100 (15% MFJ bracket ceiling), the difference of $16,600 is taxed at 0%. The $103,400 ($120,000 – $16,600) balance of the $120,000 ANCG is taxed at 15%. The tax on the other taxable income of $48,500 is computed from the tax tables (2008 Qualified Dividends and Capital Gain Tax Worksheet from Form 1040 Instructions — not shown).

Portion of Taxable Income	Applicable Tax Rate	Tax
$ 16,600	0%	$ 0
103,400	15%	15,510
48,500	Tax taken from tax table	6,473
$168,500		**$21,983**

Note. The tax on $168,500, if it all is ordinary income, is $35,924. The lower capital gains tax rates saved Jack and Mavis $13,941 in 2008. This example assumes that the AMT patch is passed for 2008.

Example 9. Rich and Judy file a joint 2008 return, which reports the following:

Wages	$50,000
Form 4835 profit from crop-share rental of farmland	25,000
Ordinary dividends ($5,000 are qualified dividends)	10,000
Taxable pension income	5,000
2008 AGI	**$90,000**
Less: exemptions (2 × $3,500 not limited by AGI)	(7,000)
Less: standard deduction (neither are age 65 or older)	(10,900)
2008 taxable income	**$72,100**

Using the formula, their **other taxable income** is $67,100:

Reported taxable income	$72,100
Less: ANCG (qualified dividends)	(5,000)
Other taxable income	**$67,100**

Tax Result for Example 9. Since $67,100 is more than $65,100 (15% MFJ bracket ceiling), none of their taxable income is taxed at 0%. The $5,000 of qualified dividends is taxed at 15%.

Example 10. Al, a retired 75-year-old single taxpayer, files a 2008 return which reports the following:

Interest income	$ 5,000
Long-term capital gain (capital-gain distributions from mutual funds)	15,000
Ordinary dividends (all are qualified dividends)	3,000
Taxable pension income	5,000
2008 AGI	**$28,000**
Less: standard deduction ($5,450 + $1,350)	(6,800)
Less: exemptions	(3,500)
2008 taxable income	**$17,700**

Using the formula, his **other taxable income** is $0.

Reported taxable income	$17,700
Less: ANCG ($15,000 long-term gain + $3,000 qualified dividends)	(18,000)
Other taxable income	**$ 0**

Tax Result for Example 10. Because zero is less than $32,550 (15% single bracket ceiling), the zero tax rate applies to his entire taxable income. Al's 2008 total tax is zero.

Note. The tax on $17,700, if it all is ordinary income, is $2,254. By utilizing the zero tax rate, Al's 2008 tax savings is $2,254.

9

Those Likely to Benefit from the Zero Tax Rate

The following taxpayers with ANCG income are most likely to benefit from the zero tax rate for 2008, 2009, and 2010:

- Retirees
- Those who have high itemized deductions, high adjustments for AGI, or claim many exemptions

Note. As **Example 8** shows, even taxpayers with high AGIs can benefit if their ANCG comprises a significant portion of their reported taxable income. Even though Jack and Mavis' 2008 AGI is $230,000, they save almost $14,000 in tax due to the lower long-term capital gain rates. Despite their high AGI, their taxable income is considerably lower due to a combination of high itemized deductions and five exemptions.

Those Not Likely to Benefit from the Zero Tax Rate

Taxpayers who are unlikely to benefit from the zero tax rate include:

- Children subject to the kiddie tax rules (see "Problem 3: Kiddie Tax Update (Form 8615)" in this chapter), and
- Those with high ordinary income such as wages, rental income, business-related income, interest income, taxable pension and IRA income, especially if their ANCG income is relatively low.

PLANNING FOR THE ZERO TAX RATE

Planning for Retired Taxpayers

Many retired taxpayers have no or insignificant wages and have the opportunity to choose which types of income to use for their living needs. For example, they often have to choose:

1. Whether to delay distributions from taxable retirement plans, including §401(k)s;
2. Whether to delay drawing social security to increase their monthly benefit; and
3. The timing of asset sales such as stock in taxable brokerage accounts, ESOP company stock, rental real estate property, and business interests (partnerships, S corporations, LLCs, etc.).

Example 11. Lou, a frugal 67-year-old single factory worker, retired on February 1, 2008. As of that date, he expects to report the following on his **2008** return:

Wages (from January)	$ 5,000
Interest income from CDs and money-market funds	2,000
Qualified dividends from stock he inherited in 2000 from his mother's estate	1,000
Taxable pension from former employer	10,000
Taxable social security ($14,000 received, but none is taxable)	0
Total estimated 2008 AGI	**$18,000**
Less: standard deduction ($5,450 + $1,350)	(6,800)
Less: exemption	(3,500)
Estimated 2008 taxable income	**$ 7,700**
Estimated 2008 tax	**$ 673**

Note. Of the 2008 estimated taxable income of $7,700, only $1,000 is ANCG.

Lou participated in the employee's investment plan — a qualified ESOP plan. He purchased company stock with after-tax money beginning in 1990. Following are the facts regarding the ESOP plan as of February 1, 2008:

Number of shares owned	4,000 shares
Value ($40 per share × 4,000 shares)	$160,000
Cost in the 4,000 shares (average of $15 per share)	(60,000)
Net unrealized appreciation	$100,000

Planning Options for Lou:

1. Lou could take a lump-sum distribution from his ESOP plan in either 2008, 2009, or 2010 and sell the 4,000 shares at various times after the distribution. Assuming the stock value remains at $40 per share during that time, Lou's sale of the distributed ESOP stock could generate significant ANCG in the year(s) Lou sells the distributed shares.

Note. The net unrealized appreciation (NUA) related to ESOP shares received in a lump-sum distribution from the plan is not taxed until the shares are sold.[37] Any gain on the sale of the ESOP stock, up to the amount of the NUA, is treated as long-term capital gain regardless of when the stock was distributed to the employee.[38] Any gain in excess of NUA is considered short-term or long-term depending on the holding period.[39] See the 2007 *University of Illinois Federal Tax Workbook*, pages 113–117 for a comprehensive explanation of distributions from ESOPs. Illinois participants should also see pages IL 18-17 to 18-19 of the 2007 workbook for special rules for Illinois residents.

2. Lou could sell the stock he inherited from his mother for a gain in 2008, 2009, or 2010 and generate a much smaller amount of ANCG.

Lou decides to take a lump-sum ESOP distribution of the 4,000 shares on February 5, 2008. He sells 500 shares on February 7, 2008, for $40 per share. His gain on the sale is $12,500, as shown on below:

Sales price of the 500 shares ($40 × 500)	$20,000
Less: cost basis ($15 × 500)	(7,500)
Long-term gain under the NUA rules for ESOP-acquired stock	**$12,500**

Consequently, Lou's 2008 tax return reports the following:

Wages (from January)	$ 5,000
Interest income from CDs and money-market funds	2,000
Qualified dividends from stock he inherited in 2000 from his mother's estate	1,000
Long-term gain on sale of the 500 shares of ESOP-acquired stock	12,500
Taxable pension from former employer	10,000
Taxable social security ($14,000 received, of which $7,475 is taxable)	7,475
Actual 2008 AGI	**$37,975**
Less: standard deduction ($5,450 + $1,350)	(6,800)
Less: exemption	(3,500)
Estimated 2008 taxable income	**$27,675**
Tax from qualified dividends and capital gain tax worksheet (not shown)	**$ 1,725**

37. IRC §402(e)(4)(A)

38. IRS Notice 98-24, 1998-1 CB 929

39. Ibid

Observations for Example 11.

1. Lou's other taxable income is $14,175:

Reported taxable income	$27,675
Less: ANCG ($12,500 long-term capital gain + $1,000 qualified dividends)	(13,500)
Other taxable income	**$14,175**

Lou's total federal tax is only $1,725 after factoring in the sale of the ESOP-acquired stock. **His additional federal tax is only $1,052 ($1,725 less estimated 2008 tax of $673) as a result of the $20,000 stock sale.** The zero tax rate applies to the $13,500 of ANCG, but the capital gain caused some of his social security to be taxable, so he did not realize a completely tax-free sale.

Note. Lou may also be liable for additional state income tax due to the stock sale.

2. Lou should consider selling additional shares of his ESOP-acquired stock in 2009 and 2010 in order to take advantage of the zero tax rate. Assuming he realizes a gain on such sales, the gains are treated as long-term for all sales after February 5, **2009.**

3. As demonstrated, creating additional ANCG in 2008, 2009, and 2010 may make social security benefits partially taxable in those years.

Example 12. Use the same facts as **Example 11,** except Lou is 65 years old (born in January 1943) when he retired on February 1, 2008. He has not yet applied for social security benefits.

Planning Options for Lou. He should consider selling enough shares of his ESOP-acquired stock in 2008, 2009, and 2010 to meet his frugal living needs for those three years. He could also delay applying for social security benefits until January 2010, when he will reach age 67. This strategy accomplishes two goals:

- He can take advantage of the zero tax rate for 2008, 2009, and 2010.
- By delaying social security benefits until he reaches age 67 in January 2010, he can increase the total of his 2010 social security benefits by 8%.[40] Delaying longer will continue to increase his benefits. However, even with the increased benefit, he may not live long enough to make this option pay off. See the "Break-Even Age Calculator" at **www.socialsecurity.gov/OACT/quickcalc/when2retire.html.**

Note. Since Lou was born in 1943, his full retirement age for social security benefits is age 66.[41] Lou turns 66 years old in January 2009.

40. www.socialsecurity.gov/retire2/delayret.htm

41. www.socialsecurity.gov/retire2/agereduction.htm

Planning for Working Taxpayers

The best advice for taxpayers with ANCG who are still generating earned income is to devise ways to keep their **other taxable income** in 2008, 2009, and 2010 from exceeding the ceiling for the 15% tax bracket. This might be accomplished in the following ways:

1. Maximize contributions to qualified retirement plans such as 401(k)s. This lowers earned income, which is the biggest component of **other taxable income.**
2. The strategy of doubling up on itemized deductions in 2008 and 2010 lowers **other taxable income** in those two years. As a result, the zero tax rate might apply to the ANCG income of those two years.
3. Convert investments that generate taxable interest income to municipal bonds (or municipal bond funds) and/or high-dividend-yielding stocks (or stock funds).

Note. In this period of very low interest rates, many municipal bond funds and stock funds are producing higher tax-free interest and taxable dividends than taxable money market funds and CDs. The dividend yield of common and preferred stock of many utility companies is also presently higher than the interest rate paid by taxable money market funds and CDs.

4. Consider buying U.S. savings I bonds. The reporting of the interest can be deferred until the I bonds are cashed.

Note. The interest rate on I bonds bought between May 1, 2008 and October 31, 2008 is 4.84%. The interest rate for all outstanding I bonds is adjusted semi-annually for inflation in May and November.[42] A new rate will be announced in November for bonds purchased between November 1, 2008 and April 30, 2009.

5. Health savings account deductions, which are taken as an AGI adjustment, can help lower **other taxable income.**

   The allowable **maximum** HSA contributions for 2008 and 2009 are:

	2008 [43]	2009 [44]
Self-only coverage	$2,900	$3,000
Family coverage	5,800	5,950
Additional contributions for HSA owners age 55 or older and not enrolled in Medicare	900	1,000

Example 13. Reed and Cindy Johnson are 60 years old and file a joint 2008 return. They contribute the maximum $7,600 to their separately-owed HSAs in 2008. Their HSA deduction lowers their 2008 **other taxable income** by $7,600. Provided **other** taxable income does not exceed $65,100, **and** they have ANCG, they could benefit from the zero tax rate.

6. SEP, SIMPLE, and qualified plans deductions for taxpayers who are self-employed or partners in a partnership can help lower **other taxable income.**
7. Traditional IRA deductions can help to lower **other taxable income.**

42. www.treasurydirect.gov/indiv/research/indepth/ibonds/res_ibonds_iratesandterms.htm and www.treasurydirect.gov/indiv/research/indepth/ibonds/res_ibonds_ifaq.htm

43. IRS Pub. 553, *Highlight of 2007 Tax Changes*

44. Rev. Prov. 2008-29, IRB 2008-22

Planning for High-Income Taxpayers

Taxpayers whose ordinary income is too high to benefit from the zero tax rate should consider gifting appreciated assets to family members whose top tax bracket will be 15% or lower in 2008, 2009, and 2010.

> **Example 14.** Derrick, a high-income professional, bought stock in 2004 that has greatly appreciated. His 85-year-old mother has been in a nursing home since 2005 and has exhausted most of her assets. Her top tax bracket for 2008 is 15%. Derrick should consider gifting his appreciated stock to his mother, which she can then sell. Her long-term gain will be eligible for the zero tax rate in 2008.
>
> However, as discussed earlier, the capital gain income could cause some of her social security benefits to be taxable. Also, increasing her AGI will reduce the amount of medical expenses she can deduct. Derrick should have his tax consultant calculate the full tax cost of transferring and selling the stock before he takes any action.

Note. This strategy generally does not apply to a taxpayer's children who are age 18 or younger, or who are full-time students between ages 19 and 23 at year end. See page 326 in this chapter.

PROBLEM 5: TRAVEL EXPENSES OF CONSTRUCTION WORKERS

BACKGROUND INFORMATION

The issue of deducting travel and transportation expenses for construction workers has resulted in many court cases. This area can be a difficult and time-consuming one for preparers due to an unintentional misunderstanding of the facts and a lack of adequate records. In many instances, a reconstruction of mileage and meals while away from home is required.

The standard mileage rate is $0.505 per mile[45] for business miles driven the first six months of 2008 and $0.585 per mile[46] for business miles driven on or after July 1, 2008. At these levels, business auto expenses, if deductible, could be a major Form 2106 expense for construction workers. This issue attempts to explain the following issues for construction workers:

1. Where is the construction worker's tax home?
2. Are the construction workers away from their tax home temporarily or indefinitely?

TAX HOME OF A CONSTRUCTION WORKER

A taxpayer's tax home is the regular place of business or post of duty, regardless of where his principal residence is located. The tax home includes the entire city or general area in which the business is located.[47] However, many construction workers do not have a regular place of work; they work at many different locations.

The following is an excerpt from IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses:*

> ***Main Place of Business or Work.*** *If you have more than one place of work, consider the following when determining which one is your main place of business or work.*
>
> - *The total time you ordinarily spend in each place.*
> - *The level of your business activity in each place.*
> - *Whether your income from each place is significant or insignificant.*

45. Rev. Proc. 2007-70, IRB 2007-50
46. Announcement 2008-63 (June 23, 2008)
47. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*

The IRS established three factors to determine a taxpayer's tax home if he has no regular place of work. The tax home is the principal residence if the answer to all of the following three questions is **Yes:**[48]

1. Does the taxpayer perform part of his work in the vicinity of his residence and does he live there while working?
2. Does the taxpayer duplicate living expenses when his work requires him to be away from his residence?
3. Does the taxpayer often use the residence for lodging, or have a family member living in the residence?

Note. In Rev. Rul. 73-529, the IRS provides two examples of taxpayers who travel extensively for business. In one example, the taxpayer satisfied condition 3 even though he only stayed at his residence for one month per year.

Application of the 3-Factor Test

- If the answer is **Yes** for all three questions, the tax home is the residence of the taxpayer.
- If the answer is **Yes** for two of the questions, the taxpayer may or may not have a tax home depending on all of the facts and circumstances.
- If the answer is **Yes** to only one of the questions, the taxpayer is considered an itinerant and has no tax home. The tax home is wherever the taxpayer works and no travel expenses can be deducted.[49]

48. Rev. Rul. 73-529, 1973-2 CB 37

49. Ibid

9

Example 15. Milt is a member of the Operating Engineers Union with headquarters in Peoria, Illinois. He and his family reside in a small town 20 miles west of Peoria. During 2008, he was unemployed for three months and his union found work for him in the following localities for the other nine months:

- The greater Peoria metropolitan area for seven months (148 work days)
- Bloomington, Illinois, during April and May (42 work days).

Note. Bloomington is 35 miles east of Peoria and is 55 miles from Milt's residence.

Tax Result for Example 15. Milt cannot answer yes to Question 2 because he does not duplicate living expenses in 2008. Therefore, Milt's tax home is not his residence. **His tax home is Peoria, where he usually works.**

Milt cannot deduct the cost of traveling between his residence and Peoria, his tax home.[50] However, since the 2-month job in Bloomington was temporary, Milt is entitled to deduct his transportation expenses from his residence to Bloomington.[51] **The round-trip mileage from his home to the temporary Bloomington job site is 110 miles.**

Caution. Rev. Rul. 99-7 states: "A taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works." The tax result in **Example 15** is based on the interpretation that because the temporary work location is located outside both the metropolitan area where the taxpayer resides and the metropolitan area where the taxpayer regularly works, the taxpayer is allowed to deduct the miles from his residence to Bloomington.

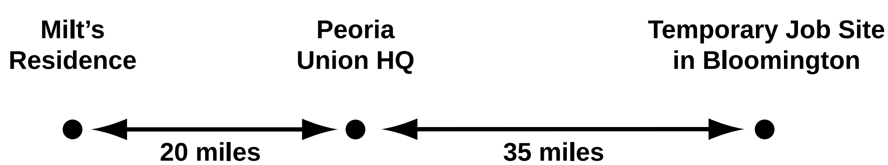
Another possible interpretation is that the ruling does not apply to Example 15 because Milt does not live in the same metropolitan area where he normally works. If Rev. Rul. 99-7 does not apply to Milt, then he can only deduct the mileage from his usual place of work (Peoria) to his temporary work location. If that is the case, Milt's allowable business mileage would be 2,940 (42 round trips × 70 miles) rather than the 4,620 business miles shown below. Therefore, his deduction would be $1,485 (2,940 × $0.505).

There is no IRS guidance specifically applicable to these facts.

Caution. The discussion of the temporary versus indefinite assignment issue is shown later.

Computation of allowable employee business expenses:

- 42 round trips from his home to the Bloomington job site × 110 miles = 4,620 business miles
- 4,620 miles × $0.505 = $2,333



50. Rev. Rul. 99-7

51. Ibid

For Example 15

Form **2106** | **Employee Business Expenses** | OMB No. 1545-0074
Department of the Treasury Internal Revenue Service (99)
▶ See separate instructions.
▶ Attach to Form 1040 or Form 1040NR.
2008 Attachment Sequence No. **54**

Your name	Occupation in which you incurred expenses	Social security number
Milt	Operating Engineer	444 44 4444

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		**Column A** Other Than Meals and Entertainment	**Column B** Meals and Entertainment
1 Vehicle expense from line 22c or line 29. (Rural mail carriers: See instructions.)	1	2,333	
2 Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3		
4 Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4		
5 Meals and entertainment expenses (see instructions)	5		
6 **Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	2,333	

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were **not** reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7		

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8	2,333	
Note: *If* ***both columns*** *of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	9	2,333	

10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 21** (or on **Schedule A (Form 1040NR), line 9**). (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶ **10** 2,333

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2008)

9

For Example 15

Form 2106 (2008) Page **2**

Part II Vehicle Expenses

Section A—General Information (You must complete this section if you are claiming vehicle expenses.)

			(a) Vehicle 1	(b) Vehicle 2
11	Enter the date the vehicle was placed in service	11	03 / 18 / 2006	/ /
12	Total miles the vehicle was driven during 2008	12	13,237 miles	miles
13	Business miles included on line 12	13	4,620 miles	miles
14	Percent of business use. Divide line 13 by line 12	14	24 %	%
15	Average daily roundtrip commuting distance	15	40 miles	miles
16	Commuting miles included on line 12	16	5,920 miles	miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12	17	2,697 miles	miles

18	Was your vehicle available for personal use during off-duty hours?	☑ Yes ☐ No
19	Do you (or your spouse) have another vehicle available for personal use?	☑ Yes ☐ No
20	Do you have evidence to support your deduction?	☑ Yes ☐ No
21	If "Yes," is the evidence written?	☑ Yes ☐ No

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)

22a	Multiply business miles driven **before** July 1, 2008, by 50.5¢ (.505)	22a	2,333
b	Multiply business miles driven **after** June 30, 2008, by 58.5¢ (.585)	22b	
c	Add lines 22a and 22b. Enter the result here and on line 1	22c	2,333

Section C—Actual Expenses

			(a) Vehicle 1	(b) Vehicle 2
23	Gasoline, oil, repairs, vehicle insurance, etc.	23		
24a	Vehicle rentals	24a		
b	Inclusion amount (see instructions)	24b		
c	Subtract line 24b from line 24a	24c		
25	Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25		
26	Add lines 23, 24c, and 25	26		
27	Multiply line 26 by the percentage on line 14	27		
28	Depreciation (see instructions)	28		
29	Add lines 27 and 28. Enter total here and on line 1	29		

Section D—Depreciation of Vehicles (Use this section only if you owned the vehicle and are completing Section C for the vehicle.)

			(a) Vehicle 1	(b) Vehicle 2
30	Enter cost or other basis (see instructions)	30		
31	Enter section 179 deduction and special allowance (see instructions)	31		
32	Multiply line 30 by line 14 (see instructions if you claimed the section 179 deduction or special allowance)	32		
33	Enter depreciation method and percentage (see instructions)	33		
34	Multiply line 32 by the percentage on line 33 (see instructions)	34		
35	Add lines 31 and 34	35		
36	Enter the applicable limit explained in the line 36 instructions	36		
37	Multiply line 36 by the percentage on line 14	37		
38	Enter the **smaller** of line 35 or line 37. If you skipped lines 36 and 37, enter the amount from line 35. Also enter this amount on line 28 above	38		

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DETERMINATION OF TEMPORARY OR INDEFINITE ASSIGNMENT

The following is an excerpt (bold type added for emphasis) from IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses:*

> ***Temporary Assignment vs. Indefinite Assignment.*** *If your assignment or job away from your main place of work is temporary, your tax home does not change. You are considered to be away from home for the whole period you are away from your main place of work. You can deduct your travel expenses if they otherwise qualify for deduction.* ***Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.***
>
> *However, if your assignment or job is indefinite, the location of it becomes your new tax home and you cannot deduct your travel expenses while there.* ***An assignment or job in a single location is considered indefinite if it is realistically expected to last for more than one year, whether or not it actually lasts for*** *more than one year...*
>
> ***Determining Temporary or Indefinite.*** *You must determine whether your assignment is temporary or indefinite when you start work. If you expect an assignment or job to last for one year or less, it is temporary unless there are facts and circumstances that indicate otherwise. An assignment or job that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.*

Example 16. Chad, who is single, belongs to the Houston Laborer's Union local. In February 2008, he was assigned by his union hall to a refinery expansion job in Weimar, Texas. The job location is 90 miles from his residence. When he began the job on February 15, 2008, he was told by his union that it would last 10 months. **However, on December 1, 2008, the union asked him to remain on the job for another four months.** He did so and the job terminated on April 20, 2009.

Question 16A. Is the refinery expansion job temporary or indefinite?

Answer 16A. It is both.

- Since Chad realistically expected the job to last only 10 months **when he began the job**, it is **temporary** from February 15, 2008, through November 30, 2008. Chad **can deduct** his travel expenses for that period.
- As of December 1, 2008, when his union requested him to remain in Weimar for another four months, it is no longer realistic for Chad to expect that the job will last for **one year or less**. Therefore, the job becomes **indefinite** from December 1, 2008, through its completion on April 20, 2009. Chad **cannot deduct** his travel expenses on or after December 1, 2008, because Weimar became his tax home when the job became indefinite.

Question 16B. What expenses may Chad deduct on his 2008 Form 2106?

Answer 16B. He can deduct the following expenses for the time period of February 15, 2008, through November 30, 2008:

- Round-trip business mileage from his Houston-area residence to the Weimar job location
- Lodging expenses in Weimar, provided he has proof for the actual amount he spent
- Meals consumed in Weimar and while traveling between his residence and the Weimar job location, subject to the 50% reduction rule

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Note. Chad could use the CONUS standard meal allowance of $39 for his away-from-home meals consumed during the period January 1, 2008 through September 30, 2008. This amount could change for meals consumed during the period October 1, 2008 through December 31, 2008. The meal allowance for the last three months of 2008 can be found on the GSA website at **www.gsa.gov.** Click on "Per Diem Rates," then select "2009" for the period October 1, 2008, through December 31, 2008. However, Chad could elect to use the $39 standard meal allowance rate for the entire year of 2008 and ignore the updated amount that takes effect on October 1, 2008.

CONCLUSION

Determining whether a job assignment is temporary or indefinite places great reliance on what the union hall (or employer, if the worker does not belong to a union) tells the worker when the job is initially assigned. Most construction projects last less than a year. The exception to that general rule would be construction of large corporate, commercial, or governmental facilities.

Note. See the *Cornelius* and the *Estate of David B. Lease* Tax Court Summary Opinion cases in the "Travel and Transportation" section of Chapter 15, "Rulings and Cases."

PROBLEM 6: BUSINESS TRAVEL AWAY FROM HOME

BACKGROUND INFORMATION

Taxpayers can deduct all ordinary and necessary business expenses.[52] Such expenses include traveling expenses (including meals and lodging expenses that are not lavish or extravagant under the circumstances) while away from home.[53]

However, under a separate code section, no deduction is allowed for personal, living, or family expenses.[54] According to the Regulations, the costs of a taxpayer's lodging **not** incurred while traveling away from home are **nondeductible** personal expenses **unless** they qualify as deductible moving expenses under §217.[55] The IRS announced that it intends to amend the regulations by adding ordinary and necessary business expenses to the exceptions to the general rule.[56]

Consequently, the IRS **will allow the deduction of lodging** expenses when the taxpayer is **not away from home** under the following conditions:

1. The lodging is on a temporary basis;
2. The lodging is necessary for the employee to participate in or be available for a **bona fide** business meeting or function of the employer; and
3. The lodging expenses are otherwise deductible by the employee, or would be deductible if paid by the employee as an ordinary and necessary business expense.[57]

---

52. IRC §162(a)
53. IRC §162(a)(2)
54. IRC §262(a)
55. Treas. Reg. §1.262-1(b)(5)
56. IRS Notice 2007-47 (June 11, 2007)
57. Ibid

MEAL EXPENSE DEDUCTION

The following is an excerpt from IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses:*

> ***Meals.*** *You can deduct the cost of meals in either of the following situations:*
>
> - *It is necessary for you to stop for substantial sleep or rest to properly perform your duties while traveling away from home on business.*
> - *The meal is business-related entertainment.*

Example 17. Lucius is employed as a short-haul truck driver for a wholesale grocery supplier. His employer provides 1-day deliveries from its terminal in Champaign, Illinois, to food stores located in Illinois and Indiana. Lucius' work day normally begins at 6 a.m. when he reports to the Champaign terminal. His work day normally ends between 6 and 7 p.m. when he returns to the terminal. He occasionally rests but never sleeps while his truck is unloaded. His employer provides no reimbursement or allowance for his meals while away from the terminal.

Tax Result for Example 17. Since it is not necessary for Lucius to stop and obtain substantial sleep or rest to perform his daily duties, he is not considered away from home. Therefore, he is not entitled to any meal deduction on his Form 2106, *Employee Business Expenses*.

Example 18. Use the same facts as **Example 17,** except Lucius occasionally works 14- to 16-hour days due to highway delays or mechanical problems. On some of these days, he sleeps in his truck seat for several hours.

Tax Result for Example 18. The tax result is the same as **Example 17** because Lucius did not stop for substantial sleep or rest.

Example 19. During one trip in **February 2008,** Lucius was forced to get a motel room due to a blizzard. He left the Champaign terminal at 6 a.m. on Tuesday morning and did not return until 6 p.m. on Wednesday evening. His employer did not reimburse him for either meals or lodging for this trip.

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Note. The tax result, shown next, is for illustrative purposes. Due to the small amount of meals and lodging expense, he most likely is not eligible for any deduction on his 2008 Schedule A due to the 2% of AGI limitation unless he has other significant miscellaneous itemized deductions.

Tax Result for Example 19. Lucius can deduct both meals and lodging for this 36-hour trip provided he has adequate records. He must have evidence to support his lodging expense. He can use the special meal allowance of $52 per day available to transportation industry workers to compute his meal deduction. He can elect to use the full standard meal allowance for both calendar days instead of prorating it using the "first and last day of a trip" rule.[58]

The computation of the meals deduction on Lucius' 2008 Form 2106 follows.

2 days @ $52	$104
Less: 20% reduction	(21)
Allowable meal deduction on Form 2106	$ 83

Note. Lucius meets the definition of a transportation-industry worker. He is entitled to a deduction of 80%[59] of his unreimbursed meals for 2008 (up from 75% in 2007). The special meal allowance for the first nine months of 2008 for transportation industry workers is $52 per day for locations within the continental United States and $58 per day for any location outside the continental United States.[60]

58. Rev. Proc. 2007-63 §6.04 IRB 2007-42; see also *Bissonnette v. Comm'r,* 127 TC 124 (2006)

59. IRC §274(n)(3)

60. Rev. Proc. 2007-63, §4.04(3), IRB 2007-41

PROBLEM 7: FORM 1099-R ISSUES

BACKGROUND INFORMATION

Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, is an information reporting form. The following payments are reported on Form 1099-R:

- Pensions
- Annuities
- IRA distributions
- Roth IRA distributions
- SIMPLE IRA distributions
- Life insurance and endowment contracts
- Profit-sharing plan distributions
- Other employer plan distributions
- Survivor income benefit plans
- Charitable gift annuities

Most 1099-R distributions create no problems for preparers. However, some situations are confusing and require special preparer attention and action. One such situation is an IRA distribution of excess contributions plus earnings.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 2008 Form 1099-R	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy B**
PAYER'S federal identification number	RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	**4 Federal income tax withheld** $	**Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.)		7 Distribution code(s) — IRA/ SEP/ SIMPLE ☐	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions $	
	1st year of desig. Roth contrib.	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
Account number (see instructions)		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

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

DISTRIBUTION CODES IN BOX 7

The codes shown in box 7 are important. Following is a brief synopsis of most of the distribution codes used in Box 7 for **2008** distributions:[61]

1. **Code 1 —** Early distribution, no known exception applies

   Code 1 is used when the taxpayer has not reached age 59½ and the payer is not aware of any exceptions under distribution codes 2, 3, or 4. Code 1 is also used when a taxpayer is 59½ or older, **but** modifies a series of substantially equal periodic payments under §72(q), (t), or (v) prior to the end of the 5-year period.

2. **Code 2 —** Early distribution, exception applies

   Code 2 is used when the taxpayer has not reached age 59½, and the payer knows that there is an exception to the 10% early distribution penalty. Usually, code 2 is used for the following distributions:

   - From a qualified retirement plan after separation from service in or after the year the taxpayer reached age 55
   - Part of a series of substantially equal periodic payments
   - A Roth IRA conversion (a traditional IRA converted to a Roth IRA)

3. **Code 3 —** Disability

   Code 3 is used when the payer knows the disability exception applies to the 10% early-distribution penalty.

4. **Code 4 —** Death

   Code 4 is used for payments to a decedent's beneficiary, including an estate or trust, regardless of the age of the decedent. The 10% early-distribution penalty does not apply.

5. **Code 6 —** Section 1035 exchange

   Code 6 is used to indicate the tax-free exchange of life insurance, annuity, or endowment contracts under IRC §1035.

6. **Code 7 —** Normal distribution

   Code 7 is used for distributions from a plan, including a traditional IRA, a §401(k), or §403(b) plan, if the taxpayer is at least 59½. Code 7 is never used for a Roth IRA.

7. **Code 8 —** Excess contributions plus earnings or excess deferrals (and/or earnings) taxable in 2008

   Code 8 is used for a **corrective IRA distribution** withdrawn on or before the due date of the return (including extensions). This applies for contributions **made in 2008** for 2007, but **withdrawn** in 2008. However, see the explanation for Code P below for contributions **made in 2007** and withdrawn in 2008. Code 8 is also used for **corrective distributions** of excess deferrals (and/or earnings) to the following:

   - §401(a) plans (qualified employer pension, profit-sharing, and stock-bonus plans)
   - §401(k) plans
   - §403(a) annuity plans
   - §403(b) salary-reduction agreements (tax-sheltered annuities)
   - §408(k)(6) salary-reduction simplified employee pensions (SARSEPs)

9

61. 2008 Instructions for Forms 1099-R and 5498

Note. Corrective distributions are reported on Form 1099-R for the year of the distribution regardless of when the distribution is taxable to the participant. Code P is used instead of code 8 for a corrective IRA distribution that is taxable in **2007.** See **Examples 20–22** shown later.

8. **Code A —** May be eligible for the 10-year averaging method on Form 4972, *Tax on Lump-Sum Distributions*

   Code A is used only for participants born before January 2, 1936, or their beneficiaries.

9. **Code F —** Charitable gift annuity

Note. See pages 100–105 in the 2007 *University of Illinois Federal Tax Workbook* for a explanation of charitable gift annuities and a thorough example with completed forms and schedules.

10. **Code G —** Direct rollover and rollover contributions

    Code G is used when a trustee makes a direct rollover from a qualified plan to another qualified plan, a §403(b) plan, or an IRA on behalf of the employee/participant.

11. **Code P —** Excess contributions plus earnings/excess deferrals taxable in 2007

    Code P is used instead of code 8 when a corrective IRA distribution withdrawn in 2008 is taxable in 2007. This applies when the contribution was made in 2007 and withdrawn in 2008. See the explanation for code 8 for contributions made in **2008** for 2007 and withdrawn in 2008. The IRS suggests that the payer should advise the recipient at the time the distribution is made that the earnings are taxable in the year in which the excess IRA contribution was made.

Note. See **Examples 20–22** shown later.

12. **Code Q —** Qualified distribution from a Roth IRA

    Code Q is used when the payer knows that the participant meets the 5-year holding period and:

    - Has reached age 59½,
    - Has died, or
    - Is disabled.

13. **Code T —** Roth IRA distribution, exception applies

    Code T is used if the payer does not know if the participant meets the 5-year holding period but the participant:

    - Has reached 59½,
    - Has died, or
    - Is disabled.

14. Code J — Early distribution from a Roth IRA

Code J is used when Code Q or T does not apply. The distribution is tax free if it does not exceed the total of:

a. Regular Roth IRA contributions, plus

b. Conversion Roth IRA contributions.

For all Roth IRA distributions, the tax-free portion of the balance is withdrawn before the taxable portion (earnings).[62] However, if any of the distribution is attributable to funds converted from a traditional IRA within five years of the conversion year, that portion of the distribution may be subject to the 10% early-withdrawal penalty. See IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*, for the ordering rules.

Note. A combination of two codes, numeric or alpha, may appear in box 7 of Form 1099-R. Pages 11 and 12 of the 2008 Instructions for Forms 1099-R and 5498 (not shown) list the allowable code combinations.

Example 20. Ann is a 55-year-old single taxpayer. She made her 2007 maximum traditional IRA contribution of **$5,000** on January 3, 2007. When her accountant, Ruth, prepared her 2007 tax return, she discovered that due to Ann's much lower-than-expected 2007 earned income, her allowable 2007 IRA contribution was limited to **$2,000.**

On March 20, 2008, Ann notified the IRA trustee of her 2007 excess IRA contribution of $3,000. The trustee made a corrective IRA distribution of $3,210 on March 28, 2008. The $3,210 consisted of:

Excess 2007 IRA contributions	$3,000
Earnings on the excess $3,000 amount (computed by the trustee)	210
Amount of corrective IRA distribution made on March 28, 2008	**$3,210**

Ann receives the following 2008 Form 1099-R from the IRA trustee in January 2009.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code **Main Street Bank**		1 Gross distribution $ **3210.00** 2a Taxable amount $ **210.00**	OMB No. 1545-0119 **2008** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy B** **Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
PAYER'S federal identification number	RECIPIENT'S identification number **222-33-4444**	3 Capital gain (included in box 2a) $	4 **Federal income tax withheld** $	
RECIPIENT'S name **Ann**		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.)		7 Distribution code(s) **P** — IRA/SEP/SIMPLE ☒	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions $	
	1st year of desig. Roth contrib.	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
Account number (see instructions)		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

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

62. IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*

Question 20A. How should Ruth proceed with the preparation of Ann's 2007 tax return?

Answer 20A. Ann's 2007 Form 1040 should report the following:

Item	Line Number on Form 1040	Amount
IRA deduction	32	$2,000
Earnings on excess 2007 IRA contribution	21 (other income)	210

The explanation for line 21 should show "Earnings on corrective distribution" or something similar. A statement may be attached to explain the $210 entry.

Ann is not liable for either the 6% penalty or the 10% early-withdrawal penalty on the $3,000 excess IRA contribution. However, the $210 of taxable earnings is subject to the 10% penalty unless Ann qualifies for one of the exceptions. In 2007, she meets none of the exceptions for waiver of the penalty.

Form **5329** | **Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts** | OMB No. 1545-0074 | 2007

Department of the Treasury
Internal Revenue Service

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

Attachment Sequence No. 29

Name of individual subject to additional tax. If married filing jointly, see instructions.	Your social security number
Ann	222 33 4444

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return	Home address (number and street), or P.O. box if mail is not delivered to your home	Apt. no.
	City, town or post office, state, and ZIP code	If this is an amended return, check here ▶ ☐

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 60, or Form 1040NR, line 55, without filing Form 5329. See the instructions for Form 1040, line 60, or for Form 1040NR, line 55.

Part I **Additional Tax on Early Distributions**
Complete this part if you took a taxable distribution, before you reached age 59½, from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040 or Form 1040NR—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	210
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: ______	2	
3	Amount subject to additional tax. Subtract line 2 from line 1	3	210
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 60, or Form 1040NR, line 55	4	21
	Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*		

Caution. IRA trustees are not consistent when preparing Form 1099-R for the year of the corrective distribution. Using the facts for **Example 20,** some IRA trustees will report the following on the 2008 Form 1099-R:

- $3,210 will be reported in both boxes 1 (gross distribution) and 2a (taxable amount) and box 2b (taxable amount not determined) will be checked.
- $3,210 will be reported in box 1 (gross distribution), box 2a (taxable amount) will be blank, and box 2b (taxable amount not determined) will be checked.

Note. The Instructions for Recipient on the reverse of Copy B of the 2008 Form 1099-R state: "For distributions from a traditional IRA, generally the payer is not required to compute the taxable amount. Therefore, the amounts in boxes 1 and 2a will be the same most of the time. See the Form 1040 or 1040A Instructions to determine the taxable amount."

Example 21. Ann, in **Example 20,** is extremely busy and doesn't want to take the time in March 2008 to contact the trustee of her IRA.

Question 21A. What should Ruth do in this situation?

Answer 21A. She should request an extension for Ann's 2007 return on Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return.* That allows Ann until October 15, 2008, to have the excess 2007 IRA contribution withdrawn. However, in that case, the corrective IRA distribution will be more than $3,210 because of increased earnings. Therefore, the other income reported on line 21 will be more than $210.

Ann will not be liable for the 6% penalty on the $3,000 excess IRA contribution if the corrective distribution is made on or before October 15, 2008, the due date of her return (including extensions). This assumes her 2007 return is filed by the extended due date. However, Ann will owe the 10% early distribution penalty on the new earnings amount.

Caution. Corrective distributions of excess deferrals to **employer-sponsored plans** must be made by the due date of the return **without** regard to extensions, generally by April 15. If the excess is taken out after April 15, it must be included in income **both** in the year of deferral and the year the distribution is received.[63]

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Example 22. Assume that Ann does not notify her IRA trustee of her 2007 excess IRA contribution of $3,000 until November 1, 2008. Ruth filed a timely 2007 return for Ann. It reported the following:

Item	Line Number on Form 1040	Amount
IRA deduction	32	$2,000
Earnings on excess 2007 IRA contribution	21 (other income)	0

The trustee made a corrective IRA distribution of $3,300 on November 10, 2008. The $3,300 consisted of:

Excess 2007 IRA contributions	$3,000
Earnings on excess $3,000 amount (computed by the trustee)	300
Amount of corrective distribution made on November 10, 2008	**$3,300**

Question 22A. What should be done in this situation?

Answer 22A. Ruth must file an amended 2007 return for Ann on Form 1040X. It will report the previously unreported $300 of earnings. The amended return will also report the following penalties:

- The 10% early-withdrawal penalty on the $300 of taxable earnings
- The 6% penalty on the $3,000 of excess contributions

This is shown on the following Form 5329.

63. IRS Pub. 525, *Taxable and Nontaxable Income*

For Example 22

Form **5329**

Department of the Treasury
Internal Revenue Service

Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

▶ Attach to Form 1040 or Form 1040NR.

▶ See separate instructions.

OMB No. 1545-0074

2007

Attachment Sequence No. **29**

Name of individual subject to additional tax. If married filing jointly, see instructions.	Your social security number
Ann	222 : 33 : 4444

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return ▶	Home address (number and street), or P.O. box if mail is not delivered to your home	Apt. no.
	City, town or post office, state, and ZIP code	If this is an amended return, check here ▶ ☐

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 60, or Form 1040NR, line 55, without filing Form 5329. See the instructions for Form 1040, line 60, or for Form 1040NR, line 55.

Part I Additional Tax on Early Distributions

Complete this part if you took a taxable distribution, before you reached age 59½, from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040 or Form 1040NR—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	300
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: ______	2	
3	Amount subject to additional tax. Subtract line 2 from line 1	3	300
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 60, or Form 1040NR, line 55	4	30
	Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*		

Part II Additional Tax on Certain Distributions From Education Accounts

Complete this part if you included an amount in income, on Form 1040 or Form 1040NR, line 21, from a Coverdell education savings account (ESA) or a qualified tuition program (QTP).

5	Distributions included in income from Coverdell ESAs and QTPs	5	
6	Distributions included on line 5 that are not subject to the additional tax (see instructions)	6	
7	Amount subject to additional tax. Subtract line 6 from line 5	7	
8	**Additional tax.** Enter 10% (.10) of line 7. Include this amount on Form 1040, line 60, or Form 1040NR, line 55	8	

Part III Additional Tax on Excess Contributions to Traditional IRAs

Complete this part if you contributed more to your traditional IRAs for 2007 than is allowable or you had an amount on line 17 of your 2006 Form 5329.

9	Enter your excess contributions from line 16 of your 2006 Form 5329 (see instructions). If zero, go to line 15			9	
10	If your traditional IRA contributions for 2007 are less than your maximum allowable contribution, see instructions. Otherwise, enter -0-	10			
11	2007 traditional IRA distributions included in income (see instructions)	11			
12	2007 distributions of prior year excess contributions (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Prior year excess contributions. Subtract line 13 from line 9. If zero or less, enter -0-			14	
15	Excess contributions for 2007 (see instructions)			15	3,000
16	Total excess contributions. Add lines 14 and 15			16	3,000
17	**Additional tax.** Enter 6% (.06) of the **smaller** of line 16 **or** the value of your traditional IRAs on December 31, 2007 (including 2007 contributions made in 2008). Include this amount on Form 1040, line 60, or Form 1040NR, line 55			17	180

Part IV Additional Tax on Excess Contributions to Roth IRAs

Complete this part if you contributed more to your Roth IRAs for 2007 than is allowable or you had an amount on line 25 of your 2006 Form 5329.

18	Enter your excess contributions from line 24 of your 2006 Form 5329 (see instructions). If zero, go to line 23			18	
19	If your Roth IRA contributions for 2007 are less than your maximum allowable contribution, see instructions. Otherwise, enter -0-	19			
20	2007 distributions from your Roth IRAs (see instructions)	20			
21	Add lines 19 and 20			21	
22	Prior year excess contributions. Subtract line 21 from line 18. If zero or less, enter -0-			22	
23	Excess contributions for 2007 (see instructions)			23	
24	Total excess contributions. Add lines 22 and 23			24	
25	**Additional tax.** Enter 6% (.06) of the **smaller** of line 24 **or** the value of your Roth IRAs on December 31, 2007 (including 2007 contributions made in 2008). Include this amount on Form 1040, line 60, or Form 1040NR, line 55			25	

For Privacy Act and Paperwork Reduction Act Notice, see page 6 of the instructions. Cat. No. 13329Q Form **5329** (2007)

Question 22B. Does Ann need to report anything on her 2008 return to show that the excess contribution was corrected?

Answer 22B. **Yes.** Ann should file a 2008 Form 5329 and complete Part III as shown below:

Part III — Additional Tax on Excess Contributions to Traditional IRAs

Complete this part if you contributed more to your traditional IRAs for 2008 than is allowable or you had an amount on line 17 of your 2007 Form 5329.

9	Enter your excess contributions from line 16 of your 2007 Form 5329 (see instructions). If zero, go to line 15			9	3,000
10	If your traditional IRA contributions for 2008 are less than your maximum allowable contribution, see instructions. Otherwise, enter -0-	10			
11	2008 traditional IRA distributions included in income (see instructions)	11			
12	2008 distributions of prior year excess contributions (see instructions)	12	3,000		
13	Add lines 10, 11, and 12			13	3,000
14	Prior year excess contributions. Subtract line 13 from line 9. If zero or less, enter -0-			14	0
15	Excess contributions for 2008 (see instructions)			15	
16	Total excess contributions. Add lines 14 and 15			16	
17	**Additional tax.** Enter 6% (.06) of the **smaller** of line 16 **or** the value of your traditional IRAs on December 31, 2008 ...				

PROBLEM 8: FOREIGN EARNED INCOME EXCLUSION (FORM 2555)

BACKGROUND

A significant number of American citizens are currently working abroad due to U.S. companies expanding internationally and military outsourcing of support services.

Even in smaller communities, a tax practitioner may find that a client has been living and working in a foreign country. Foreign income is not only earned by executives. Many of the military outsourcing jobs involve support services such as construction, food preparation, and maintenance. Although income earned by members of the U.S. Armed Forces serving in combat zones is tax free, the combat zone provisions do not apply to private citizens.

There is, however, an election available to exclude certain income of qualifying individuals. This section of the chapter is designed to give practitioners a basic understanding of the tax treatment of foreign earned income.

> **Note.** IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad* contains a comprehensive overview of federal taxation of foreign earned income and related issues. The information below was extracted from this publication, except where otherwise footnoted.

GENERAL RULES

To qualify for the foreign earned income exclusion, a U.S. citizen or resident alien must:

- Have foreign earned income,
- Have a tax home in a foreign country, **and**
- Meet either the bona fide residence test **or** the physical presence test

Foreign Earned Income

Foreign earned income (FEI) is pay for services performed in a foreign country. It includes:

- Wages
- Commissions
- Bonuses
- Self-employment income
- Allowances, such as cost-of-living allowances and overseas differentials
- Taxable reimbursements, such as nonqualified moving expenses
- Noncash income, such as certain lodging, meals, and vehicle use

FEI does **not** include:

- The value of meals and lodging excluded from income because it was furnished for the convenience of the employer
- Pension or annuity payments, including social security benefits
- Pay received as an employee of the U.S. government
- Amounts included in income because of the employer's contributions to a nonexempt employee trust or to a nonqualified annuity contract
- Any unallowable moving expense deduction that has been recaptured
- Payments received after the end of the tax year following the tax year in which the services were performed

Tax Home in a Foreign Country

Generally an individual's **tax home** is the geographical area of his main place of business or employment regardless of where the family home is located. The definition of tax home for this purpose is the same as the definition for purposes of deducting travel expenses away from home.[64]

A **foreign country** is any territory (including the airspace, territorial waters, seabed, and subsoil) under the sovereignty of a government other than the United States. The term does **not include** U.S. possessions, U.S. territories, or the Antarctic region.

> **Note.** International waters do not qualify as being in a foreign county. See the *Edward D. Clark*[65] Tax Court case in Chapter 15, "Rulings and Cases," for more information.

The Bona Fide Residence Test and the Physical Presence Test

To qualify for the FEI exclusion, a taxpayer must meet **either** the bona fide residence test **or** the physical presence test. The minimum time requirements can be waived if the taxpayer must leave a foreign country because of war, civil unrest, or similar adverse conditions in that country. At the beginning of each year, the IRS publishes a list of countries qualifying for the waiver during the previous calendar year.

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64. IRC §911(d)(3)

65. *Edward D. Clark*, TC Memo 2008-71 (Mar. 19, 2008)

The Bona Fide Residence Test. To meet this test, the taxpayer must be a bona fide resident of a foreign country for an uninterrupted period that includes an entire tax year (January 1 through December 31 for those who file on a calendar-year basis). This is actually a 2-part test:

1. Was the taxpayer a bona fide **resident** of a foreign country during the tax year?
2. Did the taxpayer reside in the foreign country for the **entire tax year**?

Part 1 is based on the facts and circumstances. The taxpayer must engage in behavior that is consistent with being a resident of the foreign country.

Part 2 is factual. Temporary trips away from the country do not disqualify the taxpayer as long as the taxpayer intends to return to her "home" in the foreign country within a reasonable amount of time.

The Physical Presence Test. To meet this test, the taxpayer must be present in the foreign country for at least 330 full days out of any 12 consecutive months. A full day is a period of 24 consecutive hours, beginning at midnight.

The physical presence test is based only on the length of stay. This test does not depend on the kind of residence, the taxpayer's intentions of returning, or the nature and purpose of the stay abroad.

QUESTIONS AND ANSWERS[66]

Question 1. What is the maximum FEI exclusion for 2008?

Answer 1. The maximum 2008 exclusion is **$87,600** for each qualifying person.

Question 2. What if both the taxpayer and spouse are qualifying people?

Answer 2. Both can exclude up to the maximum. Together they can exclude up to $175,200 of FEI for 2008.

Question 3. What is the foreign housing exclusion?

Answer 3. It is an allowance for housing costs incurred in foreign countries. It is calculated as the excess of housing costs incurred over a base amount for each day in a foreign country. **The maximum amount of the housing exclusion generally cannot exceed 30% of the maximum FEI exclusion, or $26,280 for 2008.** However, the limit varies depending upon the location of the qualifying individual's foreign tax home and the number of qualifying days in the tax year. Within the instructions to Form 2555, the IRS publishes alternative maximums based on the cost of housing in certain locations

Of the allowed housing expenses, only the amount above 16% of the FEI exclusion ($14,016 for 2008) is excludable.[67] This calculation is included in **Example 23.**

Question 4. How do the foreign housing exclusion and FEI exclusion interact?

Answer 4. The foreign housing exclusion plus the FEI exclusion cannot total more than the taxpayer's foreign earned income. The housing exclusion is calculated first.

Question 5. How are the exclusions claimed?

Answer 5. The foreign earned income exclusion and the foreign housing exclusion are claimed and calculated using Form 2555, *Foreign Earned Income*, which must be attached to Form 1040. However, if only the foreign earned income exclusion is claimed, a shorter Form 2555-EZ, *Foreign Earned Income Exclusion*, may be used. Once the choice is made to exclude foreign earned income, that choice remains in effect for the year the election is made and all later years, unless revoked.

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66. IRS Fact Sheet, *Foreign Earned Income Exclusion*, issued May 2008 as part of the International Tax Gap Series www.irs.gov/businesses/article/0,,id=182017,00.html (unless otherwise noted.)

67. IRC §911(c)

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Question 6. Can a taxpayer claim the FEI exclusion and the EIC?

Answer 6. **No.** Once the FEI exclusion is claimed, the earned income credit cannot be claimed for that year.

Question 7. Is there a difference in the exclusion if the employer is a U.S. company or a foreign company?

Answer 7. **No.** The only restriction is the FEI exclusion **cannot** be taken for wages paid by the U.S. government.[68]

Question 8. If the taxpayer has taxable income after applying the exclusion, at what rate is the remainder taxed?

Answer 8. Any taxable income remaining after the exclusion is taxed at the marginal rate that would be applicable if the taxpayer had not elected the exclusion. AMT is calculated in the same manner. For tax years beginning after December 31, 2006, there is also a special adjustment for capital gains.

Question 9. May a taxpayer claim a foreign tax credit or a deduction for foreign taxes paid if the FEI exclusion is chosen?

Answer 9. **No.** Double dipping is prohibited. Once the FEI exclusion is claimed, foreign taxes paid on the **excluded** income cannot be used for a credit or deduction.

COMPREHENSIVE EXAMPLE WITH COMPLETED FORMS

Example 23. Don is a director of manufacturing with Caterpillar, Inc. In December 2007, he and his family moved to China for a 2-year assignment where he oversees one of the plants. His 2008 compensation includes the following:

Salary	$160,000
Housing allowance	40,000
Total compensation	$200,000

Note. The housing allowance is included as wages in Box 1 of Don's 2008 Form W-2.

The only other income in 2008 for Don and his wife is $30,000 in interest income.

They spent $60,000 on qualified housing costs during 2008. Their completed Form 2555 is shown on the next three pages. The first page of their Form 1040 is shown immediately after.

Their 2008 income tax is calculated below.

A. Taxable income (Form 1040, line 43)	$112,236
B. FEI exclusion (Form 2555, line 45)	99,864
C. Total A + B	$212,100
Tax on line C	$ 48,722
Less: Tax on line B	(17,656)
Net difference: 2008 tax (Form 1040, line 44)	$ 31,066

The result of this calculation is that their taxable income is taxed at a higher rate than if the tax was determined without regard to the income excluded under the FEI provisions.

Note. For purposes of this example, assume the AMT patch is passed for 2008 with exemptions and phaseouts similar to 2007.

68. IRC §911(b)(1)(B)(ii)

For Example 23

Form **2555** | **Foreign Earned Income** | OMB No. 1545-0074

Department of the Treasury Internal Revenue Service (99)

▶ See separate instructions. ▶ Attach to Form 1040.

2008 Attachment Sequence No. **34**

For Use by U.S. Citizens and Resident Aliens Only

Name shown on Form 1040: DON FEI | Your social security number: 232 23 2323

Part I General Information

1 Your foreign address (including country): HUANGHU RD MEI YUAN WUXI JIANGSU PROVINCE 214075 CHINA

2 Your occupation: DIRECTOR OF MNFG

3 Employer's name ▶ CATERPILLAR INC

4a Employer's U.S. address ▶ 330 SW ADAMS ST PEORIA IL 61630

b Employer's foreign address ▶ CAT CAMPUS WUXI JIANGSU PROVINCE 214151 CHINA

5 Employer is (check any that apply): a ☐ A foreign entity b ☑ A U.S. company c ☐ Self d ☐ A foreign affiliate of a U.S. company e ☐ Other (specify) ▶

6a If, after 1981, you filed Form 2555 or Form 2555-EZ, enter the last year you filed the form. ▶ 2007

b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ▶ ☐ and go to line 7.

c Have you ever revoked either of the exclusions? ☐ Yes ☑ No

d If you answered "Yes," enter the type of exclusion and the tax year for which the revocation was effective. ▶

7 Of what country are you a citizen/national? ▶ UNITED STATES

8a Did you maintain a separate foreign residence for your family because of adverse living conditions at your tax home? See **Second foreign household** on page 3 of the instructions. ☐ Yes ☑ No

b If "Yes," enter city and country of the separate foreign residence. Also, enter the number of days during your tax year that you maintained a second household at that address. ▶

9 List your tax home(s) during your tax year and date(s) established. ▶ WUXI JIANGSU PROVINCE CHINA 12/01/2007

Next, complete either Part II or Part III. If an item does not apply, enter "NA." If you do not give the information asked for, any exclusion or deduction you claim may be disallowed.

Part II Taxpayers Qualifying Under Bona Fide Residence Test (see page 2 of the instructions)

10 Date bona fide residence began ▶ 12/01/2007, and ended ▶ N/A

11 Kind of living quarters in foreign country ▶ a ☐ Purchased house b ☑ Rented house or apartment c ☐ Rented room d ☐ Quarters furnished by employer

12a Did any of your family live with you abroad during any part of the tax year? ☑ Yes ☐ No

b If "Yes," who and for what period? ▶ DEB FEI, WIFE ENTIRE PERIOD

13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you are not a resident of that country? See instructions ☐ Yes ☑ No

b Are you required to pay income tax to the country where you claim bona fide residence? See instructions ☑ Yes ☐ No

If you answered "Yes" to 13a and "No" to 13b, you do not qualify as a bona fide resident. Do not complete the rest of this part.

14 If you were present in the United States or its possessions during the tax year, complete columns **(a)–(d)** below. **Do not** include the income from column **(d)** in Part IV, but report it on Form 1040.

(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)
N/A							

15a List any contractual terms or other conditions relating to the length of your employment abroad. ▶ TWO YEAR ASSIGNMENT BEGINNING DEC 2007

b Enter the type of visa under which you entered the foreign country. ▶ Z-VISA

c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation ☐ Yes ☑ No

d Did you maintain a home in the United States while living abroad? ☐ Yes ☑ No

e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 11900P Form **2555** (2008)

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For Example 23

Form 2555 (2008) Page **2**

Part III **Taxpayers Qualifying Under Physical Presence Test** (see page 2 of the instructions)

16 The physical presence test is based on the 12-month period from ▶ .... through ▶ ....

17 Enter your principal country of employment during your tax year. ▶ ....

18 If you traveled abroad during the 12-month period entered on line 16, complete columns **(a)–(f)** below. Exclude travel between foreign countries that did not involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter "Physically present in a foreign country or countries for the entire 12-month period." **Do not** include the income from column **(f)** below in Part IV, but report it on Form 1040.

(a) Name of country (including U.S.)	**(b)** Date arrived	**(c)** Date left	**(d)** Full days present in country	**(e)** Number of days in U.S. on business	**(f)** Income earned in U.S. on business (attach computation)

Part IV **All Taxpayers**

Note: *Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2008 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions.* ***Do not*** *include income from line 14, column* ***(d),*** *or line 18, column* ***(f).*** *Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.*

If you are a cash basis taxpayer, report on Form 1040 all income you received in 2008, no matter when you performed the service.

2008 Foreign Earned Income				**Amount (in U.S. dollars)**
19 Total wages, salaries, bonuses, commissions, etc. **(BOX 1 WAGES ON DON'S W-2)**			19	200,000
20 Allowable share of income for personal services performed (see instructions):				
a In a business (including farming) or profession			20a	
b In a partnership. List partnership's name and address and type of income. ▶			20b	
21 Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined):				
a Home (lodging)			21a	
b Meals			21b	
c Car			21c	
d Other property or facilities. List type and amount. ▶			21d	
22 Allowances, reimbursements, or expenses paid on your behalf for services you performed:				
a Cost of living and overseas differential	22a			
b Family	22b			
c Education	22c			
d Home leave	22d			
e Quarters	22e			
f For any other purpose. List type and amount. ▶	22f			
g Add lines 22a through 22f			22g	
23 Other foreign earned income. List type and amount. ▶			23	
24 Add lines 19 through 21d, line 22g, and line 23			24	200,000
25 Total amount of meals and lodging included on line 24 that is excludable (see instructions)			25	
26 Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your **2008 foreign earned income** ▶			26	200,000

Form **2555** (2008)

For Example 23

Form 2555 (2008) Page 3

Part V All Taxpayers

27	Enter the amount from line 26	27	200,000

Are you claiming the housing exclusion or housing deduction?
☑ **Yes.** Complete Part VI.
☐ **No.** Go to Part VII.

Part VI Taxpayers Claiming the Housing Exclusion and/or Deduction

28	Qualified housing expenses for the tax year (see instructions)	28	60,000
29a	Enter location where housing expenses incurred (see instructions) ▶ CHINA - ALL OTHERS		
b	Enter limit on housing expenses (see instructions)	29b	26,280
30	Enter the **smaller** of line 28 or line 29b	30	26,280
31	Number of days in your qualifying period that fall within your 2008 tax year (see instructions) — 31: 366 days		
32	Multiply $38.30 by the number of days on line 31. If 366 is entered on line 31, enter $14,016.00 here	32	14,016
33	Subtract line 32 from line 30. If the result is zero or less, do not complete the rest of this part or any of Part IX	33	12,264
34	Enter employer-provided amounts (see instructions) — 34: 200,000		
35	Divide line 34 by line 27. Enter the result as a decimal (rounded to at least three places), but do not enter more than "1.000"	35	× 1 . 000
36	**Housing exclusion.** Multiply line 33 by line 35. Enter the result but do not enter more than the amount on line 34. Also, complete Part VIII ▶	36	12,264

Note: *The housing deduction is figured in Part IX. If you choose to claim the foreign earned income exclusion, complete Parts VII and VIII before Part IX.*

Part VII Taxpayers Claiming the Foreign Earned Income Exclusion

37	Maximum foreign earned income exclusion	37	$87,600 00
38	• If you completed Part VI, enter the number from line 31. • All others, enter the number of days in your qualifying period that fall within your 2008 tax year (see the instructions for line 31). — 38: 366 days		
39	• If line 38 and the number of days in your 2008 tax year (usually 366) are the same, enter "1.000." • Otherwise, divide line 38 by the number of days in your 2008 tax year and enter the result as a decimal (rounded to at least three places).	39	× 1 . 000
40	Multiply line 37 by line 39	40	87,600
41	Subtract line 36 from line 27	41	187,736
42	**Foreign earned income exclusion.** Enter the **smaller** of line 40 or line 41. Also, complete Part VIII ▶	42	87,600

Part VIII Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both

43	Add lines 36 and 42	43	99,864
44	Deductions allowed in figuring your adjusted gross income (Form 1040, line 37) that are allocable to the excluded income. See instructions and attach computation	44	
45	Subtract line 44 from line 43. Enter the result here and in parentheses on **Form 1040, line 21.** Next to the amount enter "Form 2555." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	45	99,864

Part IX Taxpayers Claiming the Housing Deduction—Complete this part only if **(a)** line 33 is more than line 36 and **(b)** line 27 is more than line 43.

46	Subtract line 36 from line 33	46	
47	Subtract line 43 from line 27	47	
48	Enter the **smaller** of line 46 or line 47	48	

Note: *If line 47 is* ***more than*** *line 48 and you could not deduct all of your 2007 housing deduction because of the 2007 limit, use the worksheet on page 4 of the instructions to figure the amount to enter on line 49. Otherwise, go to line 50.*

49	Housing deduction carryover from 2007 (from worksheet on page 4 of the instructions)	49	
50	**Housing deduction.** Add lines 48 and 49. Enter the total here and on Form 1040 to the left of line 36. Next to the amount on Form 1040, enter "Form 2555." Add it to the total adjustments reported on that line ▶	50	

Form 2555 (2008)

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For Example 23

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2008 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2008, or other tax year beginning , 2008, ending , 20 OMB No. 1545-0074

Label			
(See instructions on page 12.)	Your first name and initial: DON	Last name: FEI	**Your social security number** 232 23 2323
Use the IRS label. Otherwise, please print or type.	If a joint return, spouse's first name and initial: DEB	Last name: FEI	**Spouse's social security number** 555 55 5555
L A B E L H E R E	Home address (number and street). If you have a P.O. box, see page 12. C/O TRUST DEPARTMENT LOCAL BANK	Apt. no.	You **must** enter your SSN(s) above.
Presidential	City, town or post office, state, and ZIP code. If you have a foreign address, see page 12. EAST PEORIA IL 61611		Checking a box below will not change your tax or refund.

▶ Check here if you, or your spouse if filing ... $3 to go to this fund ...

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 19.

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

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	200,000
8a	**Taxable** interest. Attach Schedule B if required		8a	30,000
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 19)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)		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	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions	15a	**b** Taxable amount (see page 21) 15b	
16a	Pensions and annuities	16a	**b** Taxable amount (see page 22) 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 24) 20b	
21	Other income. List type and amount (see page 24) FORM 2555		21	(99,864)
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	130,136
23	Archer MSA deduction. Attach Form 8853	23		

Form 1040 (2008)

Tax and Credits

Standard Deduction for—
- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent,

38	Amount from line 37 (adjusted gross income)	38	130,136
39a	Check if: ☐ **You** were born before January 2, 1944, ☐ Blind. ☐ **Spouse** was born before January 2, 1944, ☐ Blind. **Total boxes checked** ▶ 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶39b ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40	10,900
41	Subtract line 40 from line 38	41	119,236
42	If line 38 is $119,975 or less, multiply $3,500 by the total number of exemptions claimed on line 6d. If line 38 is over $119,975, see the worksheet on page 33	42	7,000
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	112,236
44	Tax (see page 33). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972	44	31,066
45	**Alternative minimum tax** (see page 36). Attach Form 6251	45	