Chapter 4: Individual Taxpayer Problems

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Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

PROBLEM 1: PLANNING FOR HIGH-INCOME TAXPAYERS

BACKGROUND INFORMATION

The years 2008 and 2009 have been historic years for all Americans. The economic turmoil and the national elections in November 2008 resulted in widespread change. At the time this book went to print, the blueprint for tax changes as outlined in President Obama's initial budget was clear. These changes are likely to apply for 2011 and later tax years and will significantly impact tax planning strategies for high-income individuals.

The goal of this section is to alert practitioners to the possible tax changes and help them formulate planning suggestions for their high-income clients.

STATISTICAL INFORMATION

The following statistics may help define the term **high-income taxpayers.** They also provide other information that allows comparison between high-income taxpayers and other tax filers.

Note. Not all tax **filers** qualify as tax **payers**. Many low-income and middle-income individuals who file tax returns have a negative income tax liability. This outcome is possible mainly due to refundable credits. The Obama administration is firmly committed to an expansion of refundable credits. See Chapter 11, New Legislation, for details on recently enacted refundable credits.

Winter 2009 Statistics of Income Bulletin[1]

The latest statistics feature information on 138.4 million individual income tax returns filed for the **2006** tax year:

- Of those returns, about 93 million, or 67%, reported total income tax greater than zero.
- The average tax rate for taxable returns was 13.8%.
- The **top 5%** of taxpayers, based on adjusted gross income (AGI), had an AGI of at least $153,542. **This group accounted for 36.7% of reported total AGI and 60.1% of reported total income tax. Their average tax rate was 20.7%.**

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1. *Statistics of Income Bulletin — Winter 2009.* Internal Revenue Service. [www.irs.gov/pub/irs-soi/09winbul.pdf] Accessed on July 29, 2009; and IRS News Rel. IR-2009-17 (Mar 3, 2009).

- Taxpayers in the **top 1%** reported an AGI of at least $388,806. **This group accounted for 22.1% of reported total AGI and 39.9% of reported total income tax. Their average tax rate was 22.8%.**
- The **bottom 50%** of taxpayers had an AGI of under $31,987. **This group accounted for 12.5% of reported total AGI and 3% of reported total income tax. Their average tax rate was 3%.**

Spring 2009 Statistics of Income Bulletin[2]

For 2006, 4.1 million individual tax returns reported AGI of $200,000 or more. These returns accounted for slightly less than 3% of the 138.4 million returns filed for 2006.

IRS Fiscal Year (FY) 2008 Enforcement Information[3]

- The IRS employed 12,599 revenue agents in FY 2008.
- The examination rate in FY 2008 for **individual taxpayers who reported AGI of $200,000 or higher** was only 2.9%. Of the total 130,751 examinations conducted on these high-income taxpayers, 59% were limited correspondence examinations. In this category of taxpayers, over 53,500 field examinations were conducted by IRS examiners nationwide during FY 2008.
- The examination rate in FY 2008 for **individual taxpayers who reported AGI of $1 million or higher** was only 5.6%. Just under 22,000 examinations were conducted on taxpayers in this category.

LIKELY INCOME TAX CHANGES (FY 2010 BUDGET PROPOSAL)[4]

Background Information

In April 2009, Congress passed a nonbinding FY 2010 budget proposal. This budget resolution closely mirrors the initial budget proposal made by President Obama in February 2009. In May 2009, the Treasury Department issued its **Green Book**, which explains and expands on the tax law changes the administration hopes to pursue in 2009 and 2010.

President Obama's plan includes the following proposed changes to current tax law:

1. Increase the marginal tax rates for individual taxpayers in the top two tax brackets beginning in 2011.
2. Index the alternative minimum tax (AMT) exemption amount, tax brackets, and phaseout floors for inflation using the 2009 rates as the base year. Make the AMT relief for nonrefundable personal credits permanent.
3. Permanently extend the 0% and 15% tax rates for qualified dividends and capital gains. These rates would apply for joint taxpayers with income less than $250,000 and for single taxpayers with income less than $200,000.
4. Make the refundable making work pay tax credit for low-income and middle-income taxpayers permanent. Currently it is only applicable to 2009 and 2010.
5. Expand the refundable earned income credit (EIC) provisions.

> **Note.** See Chapter 11, New Legislation, for an analysis of the new making work pay credit and the expanded EIC provisions.

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2. *Statistics of Income Bulletin — Spring 2009.* Internal Revenue Service. [www.irs.gov/pub/irs-soi/09sprbul.pdf] Accessed on July 29, 2009; and IRS News Rel. IR-2009-56 (May 29, 2009).

3. *Fiscal Year 2008 Enforcement Results.* Internal Revenue Service. Dec. 2008. [www.irs.gov/pub/irs-news/2008_enforcement.pdf] Accessed on July 29, 2009.

4. *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals.* Department of the Treasury. May 2009. [www.treas.gov/offices/tax-policy/library/grnbk09.pdf] Accessed on July 29, 2009.

Changes Likely

High-income taxpayers are likely to see the following four changes effective for tax years **beginning in 2011.**

Change 1: Top Tax Brackets. The top two individual income tax rates will likely increase:[5]

- The current 33% tax rate will increase to 36%.
- The current 35% tax rate will increase to 39.6%.

The top three tax rates for **2009** are:[6]

2009 Tax Rate	Single	MFJ	HoH
28%	$ 82,251–$171,550	$137,051–$208,850	$117,451–$190,200
33%	171,551– 372,950	208,851– 372,950	190,201– 372,950
35%	Over $372,950	Over $372,950	Over $372,950

Unknown inflation adjustments make it impossible to predict future tax brackets with complete accuracy. The following table shows the **approximate income brackets for the top three tax rates** for 2011.

Projected 2011 Tax Rate	Single	MFJ	HoH
28%	$ 87,000–$190,000	$146,000–$230,000	$116,000–$210,000
36%	190,001– 397,000	230,001– 397,000	210,001– 397,000
39.6%	Over $397,000	Over $397,000	Over $397,000

Observation. The Obama Administration's proposals attempt to shield families with AGIs of $250,000 or less from the higher income tax rates proposed for 2011. The amounts shown in the above table subtract the **estimated** 2011 standard deduction and personal exemption amounts from AGI. The $250,000 AGI threshold applies to **married taxpayers filing jointly.** The corresponding 2011 AGI threshold for **single taxpayers** is $200,000.

Change 2: Capital Gains and Qualified Dividends. The maximum tax rate on **net capital gains and qualified dividends** will likely increase from 15% to 20% beginning in 2011 for taxpayers in the two highest tax brackets.[7] (See the 2011 Tax Rate table above.)

Under **current law,** the 0% and 15% rates for dividends and net capital gains are scheduled to sunset after December 31, 2010. Also, the maximum tax rate on net capital gains will likely increase to 20% and the tax rate for qualified dividends will likely revert to the higher ordinary tax rates of up to 39.6% in 2011.

The Obama administration proposes these changes to current law beginning in 2011:

- Retaining the 0% rate for net capital gains and qualifying dividends in the lowest brackets,
- Retaining the 15% rate for net capital gains and qualified dividends in the 25% and 28% brackets, and
- Taxing such income in the highest two brackets at 20%.

5. Ibid, pp. 73–74.
6. 2009 Form 1040-ES, *Estimated Tax for Individuals.*
7. *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals.* p. 77. Department of the Treasury. May 2009. [www.treas.gov/offices/tax-policy/library/grnbk09.pdf] Accessed on July 29, 2009.

Example 1. Anna is an 80-year-old retired widow of a McDonald's executive. In 2011, she receives $200,000 of dividends on her McDonald's stock. Her taxable income is $290,000. Without the dividends, her taxable income is only $90,000.

Current Law Tax Result for 2011. Under current law, she owes $30,000 of 2011 income tax on the dividends ($200,000 × 15%) plus potential AMT.

Likely Tax Result for 2011 With Proposed Tax Law Changes. Under the President's proposal, Anna would owe $35,000 income tax on the dividends ($100,000 × 15% plus $100,000 × 20%) plus potential AMT. The top of the 28% bracket is estimated to be $190,000 in 2011 for single taxpayers like Anna. Therefore, the first $100,000 of her dividends will remain in the 28% bracket, which retains the 15% maximum capital gains tax rate. The maximum capital gains tax rate of 20% applies to her remaining $100,000 of dividends, which falls in the new 36% bracket.

Observation. Federal income tax statistics consistently prove that lower capital gain tax rates produce higher federal tax revenue. Whether an increase in the maximum tax rate on net capital gains beginning in 2011 will produce the opposite result is a topic of debate among politicians.

Change 3: Phaseout of Personal Exemptions. Beginning in 2011, the phaseout for the deduction of personal exemptions for high-income taxpayers will likely be restored. The starting threshold will likely be adjusted annually for inflation starting with 2009 values of $250,000 for MFJ and $200,000 for single filers.[8]

The previous formula for computing the phaseout will likely be reinstated: [9]

The deduction for personal exemptions is phased out by 2% for each $2,500 of 2011 AGI that exceeds the threshold amount (to be established by Congress). The threshold amount is indexed annually for inflation.

The **2009** AGI phaseout ranges for the personal exemptions are shown below.

Filing Status	AGI at Which Exemption Phaseout Begins	AGI at Which Exemption Is Completely Phased Out
Married filing jointly and surviving spouses	$250,200	$372,700
Single	166,800	289,300
Heads of household	208,500	331,000
Married filing separately	125,100	186,350

Note. This phaseout is limited to only 1/3 of the otherwise disallowed amount for 2008 and 2009.[10] In addition, under current law, the phaseout itself is eliminated altogether for tax years after December 31, 2009.[11] After 2010, these provisions, as enacted by EGTRRA, are scheduled to sunset. As a result, the deduction for all personal exemptions of high-income taxpayers may be entirely phased out for 2011 and future years.

8. *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals.* p. 76. Department of the Treasury. May 2009. [www.treas.gov/offices/tax-policy/library/grnbk09.pdf] Accessed on July 29, 2009.

9. IRC §151(d)(3)(B).

10. IRC §151(d)(3)(E).

11. IRC §151(d)(3)(F).

Change 4: Itemized Deductions. Beginning in 2011, the benefits of itemized deductions for taxpayers in the top two tax brackets will likely be further limited. **The budget proposal would limit the tax savings for itemized deductions to a maximum of 28%.** This expanded limitation will likely apply to all itemized deductions, including home mortgage interest and charitable contributions. In addition, the 3%–80% limitation on itemized deductions will likely be resurrected after EGTRRA sunsets. However, the level at which the limitation starts to apply would likely increase to AGIs of $250,000 for couples filing jointly and $200,000 for singles. [12]

Example 2. George and Tammy file jointly for 2011 and their taxable income falls within the new top 39.6% tax bracket. Their income consists entirely of $480,000 in wages. The total of their 2011 itemized deductions is $80,000, including $50,000 of charitable contributions and $15,000 of home mortgage interest.

Current Law Tax Result. Their itemized deductions will reduce their taxes by **$27,878.**

AGI	$480,000
Floor (see note below)	(160,000)
Excess	320,000
3% of excess	$ 9,600
Total itemized deductions	$ 80,000
Less excess	(9,600)
Allowable itemized deductions	$ 70,400
Tax rate	× 39.6%
Tax reduction	**$ 27,878**

Note. The 3%–80% reduction in itemized deductions rule for high-income taxpayers terminates for 2010 under current law but is reinstated when changes made by EGTRRA sunset in 2011. The AGI level at which the reduction starts to apply is indexed annually for inflation. For purposes of this example, the floor is assumed to be $160,000 for 2011.

Likely Tax Result With Proposed Tax Law Changes. Their itemized deductions will reduce their 2011 tax liability by $20,468. **Thus, George and Tammy's 2011 total tax will increase by $7,410 ($27,878 – $20,468).** The calculation of their tax savings is shown below:

AGI	$480,000
Floor (per budget proposal)	(250,000)
Excess	$230,000
3% of excess	$ 6,900
Total itemized deductions	$ 80,000
Less excess	(6,900)
Allowed itemized deductions	$ 73,100
Tax rate	× 28.0%
Tax reduction	**$ 20,468**

Observation. This tax law proposal will face fierce resistance in Congress. With the myriad of problems facing the housing industry and the dire financial straits of many nonprofit organizations, intense lobbying is likely to occur. The housing industry is dependent on the home mortgage deduction for principal residences and second homes. Nonprofit organizations are highly dependent on the charitable contributions deduction.

12. *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals.* p. 75. Department of the Treasury. May 2009. [www.treas.gov/offices/tax-policy/library/grnbk09.pdf] Accessed on July 29, 2009.

LIKELY ESTATE TAX CHANGES FOR 2010 AND FUTURE YEARS[13]

1. It appears likely that the estate tax repeal for 2010 will be rescinded in some form.
2. The estate tax exemption for 2010 and future years will likely remain at least $3.5 million, the 2009 exemption amount. A Senate provision would increase the exemption to $5 million.[14]
3. The current maximum estate tax rate of 45% will likely remain unchanged for 2010 and future years.
4. It appears likely that any unused estate exemption of a deceased spouse will transfer to the surviving spouse. If this proposal is enacted, the total potential estate exemption for a married couple will be $7 million beginning in 2010.[15]

Note. This proposed legislation would be of great benefit to extremely wealthy married couples. This proposed favorable law change was not enacted at the time this book went to print.

TAX-PLANNING SUGGESTIONS FOR HIGH-INCOME INDIVIDUALS

Background Information. Tax planning is difficult when Congress constantly changes tax law. High-income taxpayers need to be aware of likely tax changes, especially those that could prove detrimental to them. The proposed tax law changes previously discussed create tax-planning opportunities prior to 2011.

Planning Suggestion 1

Convert traditional IRAs to a Roth IRA in 2010 when the $100,000 modified AGI limit is eliminated.[16] The AGI limitation is terminated for any taxable year after 2009. However, an extremely taxpayer-friendly rule applies for conversions made in 2010.

The Roth conversion legislation, contained in the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), is a huge revenue raiser for the U.S. Treasury. High-income taxpayers may convert their traditional IRAs to a Roth IRA in 2010 and **exclude** the resulting taxable income from their 2010 AGIs. Instead, the taxable income from the 2010 conversion will be included in gross income in the following manner:

- Half of the taxable conversion amount is reported as gross income on the 2011 tax return.
- The remaining half is reported on the 2012 tax return.[17]

High-income taxpayers are the most likely candidates to make traditional IRA contributions because their higher tax rates produce significant tax savings. In addition, many were prohibited from making Roth IRA contributions because their AGI was over the phaseout limits.

13. *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals.* p. 125. Department of the Treasury. May 2009. [www.treas.gov/offices/tax-policy/library/grnbk09.pdf] Accessed on July 29, 2009.

14. *Amendment #873, to S. Con. Res. 13.* Library of Congress. Apr. 1, 2009. [thomas.loc.gov/cgi-bin/query/F?r111:1:./temp/~r111K2TXNs:e116258] Accessed on June 7, 2009.

15. Senate Bill #722, *Taxpayer Certainty and Relief Act of 2009*. United States Senate. [frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s722is.pdf] Accessed on June 7, 2009.

16. IRC §408A(c)(3).

17. IRC §408A(d)(3)(A)(iii) as amended by Pub. Law 109-222, effective for tax years beginning after Dec. 31, 2009.

With the future tax rates for individuals in the top two tax brackets likely being higher, converting from a traditional IRA to a Roth IRA in 2010 is a logical tax-planning strategy for high-income taxpayers for the following reasons:

- Any qualified Roth IRA distributions in future years escape taxation entirely.[18]
- Minimum distributions are not required from a Roth IRA after the owner reaches age 70½.[19]
- High-income taxpayers can use a Roth IRA to accumulate wealth in a tax-deferred manner with the goal of leaving the balance at death to heirs.
- Many high-income taxpayers have basis in their traditional IRAs which can be converted tax-free. This planning opportunity can be further exploited by first rolling over the taxable portion of the traditional IRAs into an employer-sponsored retirement account.[20] Only the balances in the taxpayer's **traditional** IRAs are taken into account when determining the amount of the distribution allocated to previously-taxed contributions.[21]

Note. A taxpayer may elect to report the entire taxable conversion amount as gross income for 2010 and forgo the general rule for 2010 conversions.[22] Because 2011 and later tax years will likely have higher marginal tax rates, this election should be considered.

Example 3. Sue, a high-income single professional, has consistently made deductible maximum traditional IRA contributions for many years. If she converts her traditional IRA to a Roth IRA in 2010, her taxable conversion amount will be $400,000. Sue's income puts her in the highest tax bracket in the years 2010 through 2012.

Tax Result if Sue Elects to Report the Entire Conversion in 2010. Her 2010 tax on the conversion will be $140,000 ($400,000 × 35%).

Note. It is assumed that the individual tax rates in effect for 2009 will be unchanged for 2010 and that the increase in her AGI does not negatively affect other items.

Tax Result if Sue Does Not Elect to Report the Entire Conversion in 2010. Her total tax liability on the $400,000 conversion amount will be:

Year	Reportable Conversion Amount	Tax Liability due to Conversion
2011	$200,000	$ 79,200 ($200,000 × 39.6%)
2012	200,000	79,200 ($200,000 × 39.6%)
Total tax liability if election is not made		**$158,400**

Note. It is assumed that Sue's 2010 top tax rate of 35% increases to 39.6% for both 2011 and 2012.

Conclusion. Sue should make the election to report her entire $400,000 conversion on her 2010 tax return because her tax saving is **$18,400** ($158,400 – $140,000).

Note. See Chapter 9, Retirement, for more information on this planning suggestion.

18. IRC §408A(d)(1).
19. IRC §408A(c)(5).
20. IRC §408A(d)(3)(A)(ii).
21. IRS Notice 87-16, 1987-1 CB 446.
22. IRC §408A(d)(3)(A)(iii) as amended by Pub. Law 109-222, effective for tax years beginning after Dec. 31, 2009.

Planning Suggestion 2

For individuals in the top two tax brackets in 2011 and future years, tax-exempt bonds and bond funds will be even more attractive.

Planning Suggestion 3

Beginning in 2011, high-income couples may benefit from remaining single. The Obama Administration's budget proposal would raise income taxes for married couples whose AGI exceeds $250,000. However, the similar threshold for single taxpayers is $200,000. When final details of the expected tax law changes for 2011 are available, careful tax planning is suggested regarding the marital status of couples when both individuals have high earnings.

Planning Suggestion 4

Even though most high-income taxpayers will likely not qualify for the 0% tax rate on net capital gains and qualified dividends, this unprecedented tax provision is scheduled to remain intact for 2009 and 2010. The 0% tax rate applies to qualified income that would otherwise remain in the 10% and 15% tax brackets. For all other brackets, a maximum rate of 15% applies to net capital gains and qualified dividends.

The 0% and 15% rates for dividends and capital gains are scheduled to sunset for taxable years beginning after December 31, 2010. In 2011, the maximum rate on capital gains increases to 20%, while the tax rates for dividends reverts to the higher ordinary tax rates of up to 39.6%. However, if the proposed changes are adopted, the maximum rate for dividends will be 20%.

If a high-income taxpayer's 2009 and/or 2010 gross income includes significant net capital gains and qualified dividends, the zero rate could benefit the taxpayer. Closely-held corporations with sufficient cash flow should consider paying dividends to their shareholders in 2009 and 2010.

> **Note.** See pages 331–338 in the 2008 *University of Illinois Federal Tax Workbook,* for tax-planning tips regarding the zero tax rate. This can be found on the accompanying CD.

Planning Suggestion 5[23]

High-income taxpayers, especially those who reside in states with high state income tax rates, should consider moving their tax home to a more tax-friendly state. Listed below are seven states that impose no state income tax on individuals:

- Alaska
- Florida
- Nevada
- South Dakota
- Texas
- Washington
- Wyoming

New Hampshire and Tennessee tax only dividends and interest income at 5% and 6%, respectively.

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23. *CCH Online*. Bonacum, L. and Allen, N. Jan. 2009. Commerce Clearing House, a Wolters Kluwer business. [www.cch.com/wbot2009/022Retirement.asp] Accessed on Apr. 22, 2009.

Many states, including Illinois, are trying to cope with huge budget deficits. The trend in many of these cash-strapped states is to increase the state income tax rates for individuals and business entities.

High-income retirees should consider a state's taxation of retirement income even if they don't want to move to one of the seven states that impose no state income tax. Illinois, Mississippi, and Pennsylvania exempt income from both social security benefits and traditional pension income from taxation.

> **Note.** For comprehensive coverage of taxation by state, see *CCH Outlines Tax Considerations for Retirees Searching for Tax-Friendly States* at **www.cch.com/wbot2009/022Retirement.asp.**

The state with the biggest budget shortfall is California, which is in the process of deciding which types of state taxes must be increased.[24]

Planning Suggestion 6

High-income taxpayers should consider whether to take advantage of the waiver of the required minimum distribution (RMD) rule from qualified retirement plans and traditional IRAs for calendar year 2009.[25] This one-time waiver will benefit, at least for the 2009 tax year, retired employees and owners of traditional IRAs who are at least age 70½ in 2009.

Example 4. Frank, a wealthy widower, reached age 70½ in 2009. He was planning to take the RMD for 2009 from both his former employer's 401(k) plan and his traditional IRA in December. Frank's tax preparer advises him to take advantage of the waiver for the following reasons:

- He does not need the distributions for his living needs because he has other substantial 2009 income.
- He lives in a state which taxes pension and IRA distributions at a high tax rate.
- Frank is in poor health and his will provides that his estate will pass to his only son at his death. If he dies, he will have no taxable estate and his only heir is in the 15% tax bracket.
- By taking advantage of the waiver, his 2009 social security benefits may not be taxable.

> **Note.** Under current law, the waiver applies only to RMDs required for calendar year 2009. However, Congress may extend the waiver for 2010 RMDs. When this book went to print, Congress had taken no action on extending the waiver. See Chapter 9, Retirement, for more information on this planning suggestion.

24. *Center on Budgeting and Policy Priorities.* Lav, I. J. and McNichol, E. May 18, 2009. [www.cbpp.org/cms/index.cfm?fa=view&id=711] Accessed on June 7, 2009.

25. IRC §401(a)(9)(H).

PROBLEM 2: NONQUALIFIED USE OF PRINCIPAL RESIDENCE[26]

BACKGROUND INFORMATION

The Housing Assistance Tax Act of 2008 (HATA), which was signed by President Bush on July 30, 2008, included a tax provision aimed at taxpayers who owned more than one residence. **HATA provides a major restriction in the calculation of excludable gains from the sale of a principal residence.** The result is a potential limitation to the $250,000/$500,000 exclusion rules on gain from the sale of a main home. This new provision applies when two tests are met:

1. The sale of the residence occurs on or after January 1, 2009.
2. The residence was used for a **nonqualified use** prior to its sale.[27]

Any nonqualified use of the residence prior to January 1, 2009, is disregarded for purposes of computing the excludable gain for sales on or after that date.

Caution. The determination of periods of nonqualified use of any residence on or after January 1, 2009 will require recordkeeping by owners of the residence. Exact dates of any nonqualified use on or after January 1, 2009, are necessary in order to properly calculate the amount of excludable IRC §121 gain for sales of principal residences occurring on or after January 1, 2009.

EXPLANATION OF NEW LAW

Even if the 2-out-of-5-years ownership and use tests are met by the taxpayer for the sale of a principal residence on or after January 1, 2009, any gain on its sale allocated to **nonqualified use** of the residence does not qualify for the $250,000/$500,000 exclusion.

Note. This new provision does not diminish the $250,000/$500,000 allowable exclusion under IRC §121. Instead, it adversely affects the calculation of the gain on the sale of a principal residence that qualifies for the exclusion.

Furthermore, the ownership and use tests must be met first in order to exclude any of the gain. The nonqualified-use test is a separate and distinct test **in addition** to the now familiar 2-out-of-5-years tests.

Question 1. What is nonqualified use?

Answer 1. In general, nonqualified use is any period (other than the portion of any period prior to January 1, 2009) during which the property is **not used as the principal residence** of the taxpayer or spouse.[28]

26. IRC §121(b)(4), added by P.L. 110-289, effective for tax years beginning after Dec. 31, 2008.

27. Ibid.

28. IRC §121(b)(4)(C)(i).

Question 2. What are some common examples of nonqualified use?

Answer 2. A period of nonqualified use would include the following (assuming the use occurred on or after January 1, 2009):

- The period the principal residence is used as **rental property**
- The period the principal residence is used as a **vacation home** (as opposed to used as a principal residence of the taxpayer)
- The period the principal residence is used to **renovate, improve, or enlarge the property** prior to the date the taxpayer actually moves into his principal residence
- The period during which a taxpayer **allows a friend or relative to use the property** regardless of whether fair rental income is received
- The period of time the property was **used in a trade or business**

Question 3. What is the formula for calculating the **taxable gain** under IRC §121 for a sale of a principal residence in which nonqualified use occurs?

Answer 3. Calculation of the taxable gain is a 2-step process:[29]

Step 1. Compute the gain on the sale.

Step 2. Multiply the Step 1 gain amount by a fraction composed of:

$$\frac{\textbf{The total of all periods of nonqualified use on or after January 1, 2009}}{\textbf{The entire period the property was owned by the taxpayer}}$$

The result is the portion of the gain that is **not eligible** for the $250,000/$500,000 exclusion, and is, therefore, taxable.

Note. The exact period of nonqualified use normally will be calculated in **days** rather than years. However, **Examples 5, 6,** and **7** which follow compute the period of nonqualified use in **years** for simplification purposes.

Example 5. Lucy, a single taxpayer, bought a single-family residence in Texas as a vacation home on January 1, 2009. She paid $400,000 for it. She resides in her principal residence located in Illinois, where she works full-time.

She uses her Texas home for short vacations during a 3-year period from January 1, 2009, through December 31, 2011.

She retires and sells her Illinois principal residence in 2011. On January 1, 2012, she moves to her Texas home and begins using it as her principal residence.

She sells the Texas home on January 1, 2014, for $600,000.

Tax Result.

Step 1. Calculate the 2014 gain on the sale of her Texas principal residence:

Sales price on January 1, 2014	$600,000
Less: adjusted basis	(400,000)
Gain on the sale	**$200,000**

29. IRC §121(b)(4)(B).

Step 2. Multiply the $200,000 gain by the fraction that is shown below:

$$\frac{\text{3 years of nonqualified use on/after January 1, 2009 (vacation home use)}}{\text{5 years of ownership (January 1, 2009 to January 1, 2014)}} = 60\%$$

Step 1 gain	$200,000
Multiply by Step 2 fraction	× 60%
Taxable portion of gain	**$120,000**

Therefore, $120,000 of the $200,000 gain on the sale of the residence is taxable. The remaining $80,000 of gain ($200,000 – $120,000) is eligible for the IRC §121 $250,000 exclusion. Lucy reports the sale on her 2014 Schedule D, *Capital Gains and Losses*. Her tax liability on the $120,000 long-term gain (assuming the 20% tax rate applies) is $24,000.

Note. Under **old tax law,** the entire $200,000 gain would have been excluded and Lucy would pay no tax on the gain. Therefore, the HATA revision to IRC §121 costs Lucy $24,000 of extra federal income tax in 2014.

Example 6. Tom and Jerri, a married couple, bought a California vacation home on January 1, 1993. They use it through December 31, 2010, several weeks per year for vacations (a full 18-year period).

After their retirements, they move into their former vacation home on January 1, 2011. They use it as their principal residence for two years (January 1, 2011, through December 31, 2012).

They sell the home on January 1, 2013, and realize a $300,000 gain (no depreciation was claimed on the home because it was never rented).

Tax Result. Tom and Jerri's period of nonqualified use on or after January 1, 2009, is the 2-year period from January 1, 2009 through December 31, 2010, when they used it as a vacation home.

The entire period of time they owned the home is 20 years (January 1, 1993, when they bought it, to January 1, 2013, when it was sold)

Their fraction of nonqualified use on or after January 1, 2009, divided by their entire period of ownership is:

$$\frac{\text{2 years of nonqualified use on or after January 1, 2009}}{\text{20 years of ownership}} = 10\%$$

1. 10% of their $300,000 gain, or $30,000, is **not** eligible for the $500,000 maximum exclusion. Therefore, they must report a $30,000 long-term capital gain on their 2013 Schedule D, Part II.
2. The remaining $270,000 of gain is excludable.

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 Principal residence	01/01/1993	01/01/2013	380,000	80,000	300,000
Section 121 exclusion					(270,000)
9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . 9					
10 **Total long-term sales price amounts.** Add lines 8 and 9 in column (d) . . . 10			380,000		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . 11					
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . 12					
13 Capital gain distributions. See page D-2 of the instructions . . . 13					
14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . . 14					( )
15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back . . . 15					30,000

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2013**

Question 4. Are there any exceptions to the definition of nonqualified use (shown in **Answer 2** on page 119)?

Answer 4. Yes, there are **three** exceptions.

Exception 1. Nonqualified use does **not** include any portion of the 5-year period ending on the date of sale which occurs **after the last date that the property is used as a principal residence** of the taxpayer or spouse.[30]

Example 7. Ryan, a single taxpayer, buys a single-family home for $400,000 on January 1, 2009. He rents the home for a 2-year period from January 1, 2009, through December 31, 2010, and claims a total of $20,000 of MACRS depreciation on it.

On January 1, 2011, Ryan converts the home to his principal residence. He lives in it for two years through December 31, 2012.

He moves out of the home on January 1, 2013, and the home is vacant all of 2013. He sells the home for $500,000 on January 1, 2014.

> **Note.** Since the two years of rental use occurred on or after January 1, 2009, Ryan is not entitled to exclude the entire $100,000 of gain remaining after the adjustment for prior taxable depreciation.

[30] IRC §121(b)(4)(C)(ii)(I).

Step 1. Computation of Ryan's gain on the 2014 sale of the home:

Sales price on January 1, 2014	$500,000
Less: adjusted basis ($400,000 – $20,000 prior depreciation)	(380,000)
Gain on the sale	**$120,000**

Step 2. Computation of Ryan's 2014 taxable and excludable gains under the revised rules:

The gain from Step 1 is allocated as follows:

Total gain calculated in Step 1	$120,000
Less: taxable unrecaptured §1250 gain (due to depreciation)[31]	(20,000)
Remaining gain	$100,000
Less: taxable §121 gain ($100,000 remaining gain × 40%)	(40,000)
Excludable §121 gain ($100,000 – $40,000)	$ 60,000

Explanation of Step 2.

During the 5-year period Ryan owned the home, the property was rented for two full years (2009 and 2010). This 2-year period is nonqualified use.

During 2013, the last year of the 5-year period, the home was vacant. This vacancy occurred **after** the last date Ryan used the property as his principal residence (December 31, 2012). Therefore, 2013 is **not** counted as a period of nonqualified use.[32] If Ryan had rented the home for all of 2013, the tax result would be the same.

Therefore, Ryan's nonqualified-use ratio for his 5-year period of ownership is 40% (two years out of the five years that he owned the home).

Ryan meets the 2-out-of-5-years **ownership and use tests** under the exclusion rules of IRC §121.[33] Therefore, he is entitled to exclude the remaining $60,000 of gain on the 2014 sale.

Caution. Ryan must meet the 2-out-of-5-years ownership and use tests to exclude any portion of the gain. Assume that Ryan does not meet any of the exceptions to the ownership and use tests. If Ryan had lived in the home only one year (all of 2011) and the home was vacant for the next two years, his entire $100,000 of remaining gain would be taxable. This is true even though his **nonqualified use** occurred **before** he used the property as his main home.

Exception 2.[34] HATA retains the exception for **qualified official extended duty** for members of the:

- Uniformed services,
- Foreign service, and
- Intelligence community.

Nonqualified use does **not** include the time a member is on qualified official extended duty. The maximum period that can be excluded under this provision is 10 years.

31. IRC §121(d)(6).
32. IRC §121(b)(4)(C)(ii)(I).
33. IRC §121(a).
34. IRC §121(b)(4)(C)(ii)(II).

Example 8. Rita, a single individual and an Army major, buys a home on December 31, 2006 in the District of Columbia. She uses it as her principal residence through 2009 (more than a 2-year period). Beginning on January 5, 2009, she is assigned by the Army to serve for four years in Europe. She returns home on February 1, 2013, and lives in the home until she sells it on December 31, 2013.

Tax Result. Rita may elect to suspend the 2-out-of-5-years ownership and use tests during her 4-year foreign assignment. Therefore, even if she rents the home for the 4-year period she is absent from the United States, those four years are disregarded for determining the 2-out-of-5-years tests ending on the date she sells the home. Consequently, she could still qualify for the full $250,000 exclusion if she sells the home for a gain in 2013.

Note. The extended-duty exception under the HATA provisions is not an election, unlike the provisions under the 2-out-of-5-years tests.

Exception 3.[35] HATA retains the exception for temporary absences due to a change in employment, health conditions, or unforeseen circumstances. Under this exception, the aggregate period of temporary absences cannot exceed two years.

Therefore, nonqualified use will **not** include these periods of temporary absences from the residence on or after January 1, 2009.

Note. The exception for taxpayers who do not meet the 2-out-of-5-years **use** test because they are incapable of self care[36] also applies to the nonqualified-use test. Under that exception, taxpayers are allowed to treat the time spent in a **licensed care facility** as if they were living in their principal residence, as long as at least one year in the past five was actually spent in the residence. By definition, use as a principal residence is qualified use.[37]

Summary. This tax law change to the extremely taxpayer-friendly exclusion rules of IRC §121 is apparently aimed at higher-income taxpayers. However, many taxpayers with lower incomes own second homes, either through a purchase or inheritance.

This provision is expected to raise $1.4 billion of additional tax revenue over the 10-year period beginning in 2009.[38]

Caution. Practitioners should inform their clients about the following adverse results of this potential narrowing of the §121 rules:

1. Records need to be maintained for exact dates of nonqualified use of second homes that occur on or after January 1, 2009.
2. Records need to be maintained for determining the cost basis of second homes, including the cost of improvements made.

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35. IRC §121(b)(4)(C)(ii)(III).

36. IRC §121(d)(7).

37. IRC §121(b)(4)(C)(i).

38. Rose, K. (2008, Dec.). New Rules Seek to Reduce Tax Advantages of Converting Second Home to Principal Residence. *The Tax Advisor,* 802. [www.aicpa.org/pubs/taxadv/dec2008/taxclinic.pdf#nameddest=7] Accessed on June 8, 2009.

PROBLEM 3: HSA UPDATE

BACKGROUND INFORMATION

HSA-Related Forms. Practitioners must deal with the following forms when preparing tax returns for clients with health savings accounts (HSAs):

1. Form 8889, *Health Savings Accounts (HSAs)*, is used to compute:
   - HSA deductions, on line 25 of the 2009 Form 1040
   - Taxable portion of any HSA distributions, on line 21 of the 2009 Form 1040
   - Additional 10% tax on nonqualified distributions, on line 60 of the 2009 Form 1040
2. Form 5498-SA, *HSA, Archer MSA, or Medicare Advantage MSA Information,* is similar to a Form 5498 for IRAs
3. Form 1099-SA, *Distributions From an HSA, Archer MSA, or Medicare Advantage MSA*

As healthcare costs continue to skyrocket, the pairing of a high-deductible health plan (HDHP) with an HSA can be an attractive option. This is true for employers, employees, and other individuals who are not covered by an employer's health plan.

An HSA paired with the required HDHP offer these advantages:

- Any allowable HSA contributions are deducted in arriving at AGI. Therefore, taxpayers who do not itemize can convert what would be nondeductible medical expenses into deductible HSA contributions. That same rationale applies to taxpayers who itemize but are entitled to no medical deduction due to the 7.5% AGI limitation.
- Earnings on HSA balances are not taxed if used for medical purposes.
- Distributions used for qualified medical expenses are not taxed.
- HDHPs will likely have lower premiums than conventional health insurance plans.

The tax advantages of HSA deductions are especially attractive to high-income taxpayers.

Example 9. Renee is a retired wealthy widow who is not yet eligible for Medicare. She is 60 years old and in excellent health. She established her self-only HDHP during 2009 and contributed the maximum $4,000 to her HSA for 2009. She has no other health plan and is in the 33% tax bracket.

Her federal tax savings attributable to her 2009 HSA contribution and deduction is $1,320 ($4,000 × 33%).

Note. Renee will also realize additional state income tax savings. If she resides in Illinois, her $4,000 2009 HSA deduction will save her $120 ($4,000 × 3%). In addition, the contribution lowers her AGI for other tax provisions, such as limits on itemized deductions.

INFLATION-ADJUSTED HSA AMOUNTS FOR 2009[39] AND 2010[40]

The allowable **maximum** HSA contribution amounts for 2009 and 2010 are:

	2009	2010
Self-only HDHP coverage	$3,000	$3,050
Family HDHP coverage	5,950	6,150
Additional contributions for HSA owners age 55 or older and not enrolled in Medicare	1,000	1,000

The inflation-adjusted amounts for HDHPs for 2009 and 2010 are:

	2009	2010
Minimum annual deductible for self-only coverage HDHP	$ 1,150	$ 1,200
Maximum annual out-of-pocket expenses for self-only coverage HDHP (deductibles, co-payments, and other amounts)	5,800	5,950
Minimum annual deductible for family coverage HDHP	2,300	2,400
Maximum annual out-of-pocket expenses for family coverage HDHP (deductibles, co-payments, and other amounts)	11,600	11,900

HSA QUESTIONS AND ANSWERS

Question 1. Is a 65-year-old taxpayer who has both a self-only HDHP and an HSA permitted to contribute the maximum $4,000 ($3,000 + $1,000 catch-up) to his HSA for 2009?

Answer 1. Yes, if he is **not enrolled** in Medicare at any time during 2009. If he is enrolled in Medicare for the entire year, he is prohibited from making contributions to his HSA.[41]

Example 10. Luke turned age 65 on May 23, 2009, and enrolled in Medicare (Parts A and B) on July 1, 2009. He wants to contribute to his HSA.

Tax Result. Luke's 2009 maximum HSA contribution is limited based on the number of months he participates in Medicare. Therefore, he is entitled to a maximum contribution and deduction of only $2,000 (($3,000 + $1,000 = $4,000) × (6 ÷ 12)). He is permitted to make a monthly contribution of $333.33 for the first six months of 2009. He is not eligible to make any 2009 HSA contributions for the last six months of the year.

See the *Line 3 Limitation Chart and Worksheet* found in the Instructions for Form 8889 (modified for 2009) shown next, completed for this example.

39. Rev. Proc. 2008-29, 2008-22 IRB 1039 (June 2, 2008).

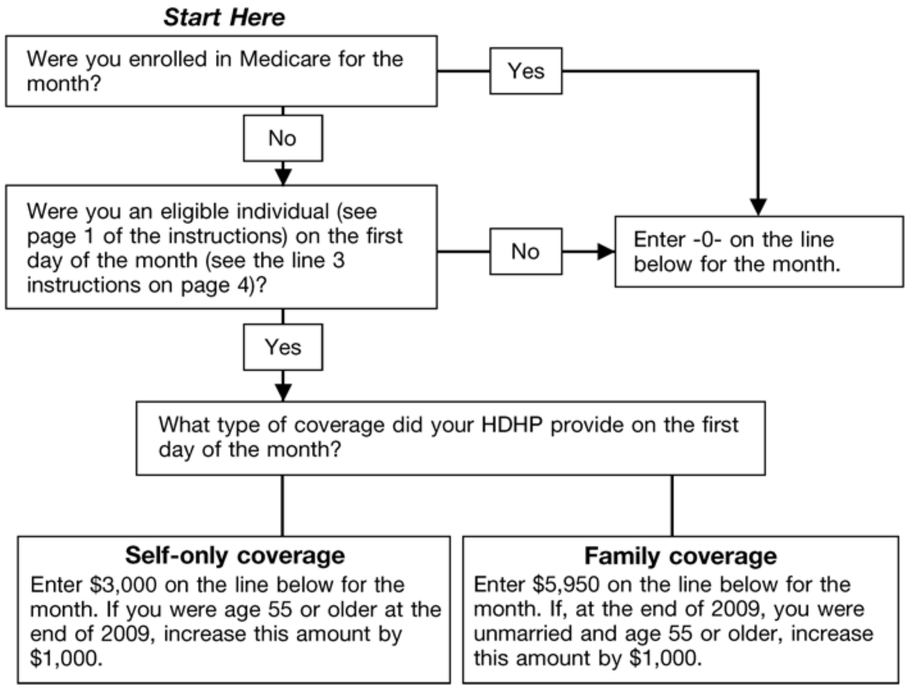
40. Rev. Proc. 2009-29, 2009-22 IRB 1050 (June 1, 2009).

41. IRC §223(b)(7). See also IRS Notice 2004-50, 2004-2 CB 196 Q&A-2.

For Example 10

Line 3 Limitation Chart and Worksheet

Go through this chart for each month of 2009.
See the instructions for line 3 on page 4.
(Keep for your records)



Month in 2009	Amount from chart above
January	4,000
February	4,000
March	4,000
April	4,000
May	4,000
June	4,000
July	0
August	0
September	0
October	0
November	0
December	0
Total for all months	24,000
Limitation. Divide the total by 12. Enter here and on line 3.	2,000

Question 2. In 2009, an individual is covered by an employer's **limited-purpose** health reimbursement arrangement (HRA). The limited-purpose HRA reimburses the employee for the following expenses:

- Vision, dental, and preventive care expenses
- Premiums for coverage under an accident and health plan

Is this individual eligible to contribute to an HSA for 2009?

Answer 2. Yes.[42] These types of coverage are specifically permitted. Coverage under most other medical expense plans disqualifies an individual from contributing to an HSA.

Question 3. In 2009, Bob, a 50-year-old married individual, establishes a family-coverage HDHP as his family's only health insurance plan on December 1, 2009. His employer makes no contributions to his HSA for 2009. His wife Debbie is age 54 at the end of 2009. Bob wants to contribute the maximum allowable to his HSA for 2009. How much can he contribute?

Answer 3. He may contribute $5,950. An individual who is an eligible individual on the first day of the last month of the year is treated as having been an eligible individual for the entire year.[43]

Note. Given the facts in **Question 3,** it is **not** necessary that Debbie establish her own HSA. However, if she was age 55 or over in 2009 and if she wanted to make the additional $1,000 catch-up HSA contribution, she must have a separate HSA in her own name.

If Bob makes his allowable 2009 HSA contribution of $5,950 by April 15, 2010, he may deduct it on his 2009 Form 8889.

If both Bob and Debbie are age 55 or over in 2009, their maximum allowable HSA contribution and deduction are $7,950. This is provided they each have separate HSAs in their own names.

42. IRS Notice 2008-59, 2008-29 IRB 123, Q&A-1 (July 21, 2008).

43. IRC §223(b)(8)(A).

For Answer 3

Form **8889** | Department of the Treasury Internal Revenue Service

Health Savings Accounts (HSAs)

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

OMB No. 1545-0074 | 2009 | Attachment Sequence No. 53

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

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

Part I **HSA Contributions and Deduction.** See page 3 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse.

1	Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2009 (see page 4 of the instructions) . . . ▶ ☐ Self-only ☑ Family		
2	HSA contributions you made for 2009 (or those made on your behalf), including those made from January 1, 2010, through April 15, 2010, that were for 2009. **Do not** include employer contributions, contributions through a cafeteria plan, or rollovers (see page 4 of the instructions)	2	5,950
3	If you were under age 55 at the end of 2009, and on the first day of **every** month during 2009, you were, or were considered, an eligible individual with the **same** coverage, enter $3,000 ($5,950 for family coverage). All others, see page 4 of the instructions for the amount to enter .	3	5,950
4	Enter the amount you and your employer contributed to your Archer MSAs for 2009 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2009, also include any amount contributed to your spouse's Archer MSAs	4	0
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	5,950
6	Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2009, see the instructions on page 4 for the amount to enter	6	5,950
7	If you were age 55 or older at the end of 2009, married, and you or your spouse had family coverage under an HDHP at any time during 2009, enter your additional contribution amount (see page 5 of the instructions)	7	
8	Add lines 6 and 7	8	5,950
9	Employer contributions made to your HSAs for 2009 . . . . **9** 0		
10	Qualified HSA funding distributions **10**		
11	Add lines 9 and 10	11	0
12	Subtract line 11 from line 8. If zero or less, enter -0-	12	5,950
13	**HSA deduction.** Enter the **smaller** of line 2 or line 12 here and on Form 1040, line 25, or Form 1040NR, line 25	13	5,950
	Caution: *If line 2 is more than line 13, you may have to pay an additional tax (see page 5 of the instructions).*		

Question 4. Use the same facts as **Question 3,** except Bob's employer contributed $2,000 to his HSA for 2009. What is Bob's maximum allowable HSA contribution for 2009?

Answer 4. His maximum allowable contribution amount is $3,950.

Form **8889** — **Health Savings Accounts (HSAs)**
Department of the Treasury Internal Revenue Service
▶ Attach to Form 1040 or Form 1040NR. ▶ See separate instructions.
OMB No. 1545-0074 — 2009 — Attachment Sequence No. 53

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

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

Part I **HSA Contributions and Deduction.** See page 3 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse.

1	Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2009 (see page 4 of the instructions) ▶ ☐ Self-only ☑ Family		
2	HSA contributions you made for 2009 (or those made on your behalf), including those made from January 1, 2010, through April 15, 2010, that were for 2009. **Do not** include employer contributions, contributions through a cafeteria plan, or rollovers (see page 4 of the instructions)	2	3,950
3	If you were under age 55 at the end of 2009, and on the first day of **every** month during 2009, you were, or were considered, an eligible individual with the **same** coverage, enter $3,000 ($5,950 for family coverage). All others, see page 4 of the instructions for the amount to enter	3	5,950
4	Enter the amount you and your employer contributed to your Archer MSAs for 2009 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2009, also include any amount contributed to your spouse's Archer MSAs	4	0
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	5,950
6	Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2009, see the instructions on page 4 for the amount to enter	6	5,950
7	If you were age 55 or older at the end of 2009, married, and you or your spouse had family coverage under an HDHP at any time during 2009, enter your additional contribution amount (see page 5 of the instructions)	7	
8	Add lines 6 and 7	8	5,950
9	Employer contributions made to your HSAs for 2009 — 9: 2,000		
10	Qualified HSA funding distributions — 10:		
11	Add lines 9 and 10	11	2,000
12	Subtract line 11 from line 8. If zero or less, enter -0-	12	3,950
13	**HSA deduction.** Enter the **smaller** of line 2 or line 12 here and on Form 1040, line 25, or Form 1040NR, line 25	13	3,950
	Caution: *If line 2 is more than line 13, you may have to pay an additional tax (see page 5 of the instructions).*		

Question 5. Use the same facts as **Question 4.** How does Bob's employer report the amount it contributes to Bob's HSA for 2009?

Answer 5. It is reported in box 12 of Bob's 2009 Form W-2 with the code W.[44]

a Employee's social security number 444-44-4444	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at www.irs.gov/efile.
b Employer identification number (EIN) 37-1111111	1 Wages, tips, other compensation 30000.00	2 Federal income tax withheld 2753.00
c Employer's name, address, and ZIP code Go Green, Inc.	3 Social security wages 30000.00	4 Social security tax withheld 1860.00
	5 Medicare wages and tips 30000.00	6 Medicare tax withheld 435.00
	7 Social security tips	8 Allocated tips
d Control number	9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial Bob / Last name / Suff.	11 Nonqualified plans	12a See instructions for box 12 Code W 2000.00
	13 Statutory employee ☐ Retirement plan ☒ Third-party sick pay ☐	12b Code
	14 Other	12c Code
f Employee's address and ZIP code		12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement **2009**

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Note. An employer's contribution to an employee's HSA is not subject to income tax withholding, social security, Medicare, or FUTA tax if it is reasonable to believe at the time of payment that the contribution will be excludable from the employee's income.[45] Otherwise, the amount is reported in boxes 1, 3, and 5.

Question 6. Dave and Sue, a married couple, are both over age 65 and enrolled in Medicare for all of 2009. They each have HSAs with large balances at the end of 2008. Are they each permitted to receive a 2009 tax-free distribution from their HSAs to pay premiums on their separate qualified long-term care insurance contracts?

Answer 6. **Yes.**[46] Generally, HSA distributions may not be used to pay for health insurance premiums.[47] But an exception is made for premiums paid for the following types of coverage:[48]

- A qualified long-term care insurance contract
- A health plan during a period in which an individual is receiving unemployment compensation under federal or state law
- Healthcare continuation coverage (such as coverage under COBRA)
- Medicare (Parts B and D) and other healthcare coverage if the HSA owner is age 65 or older (other than premiums for a Medicare supplemental policy, such as Medigap)

44. 2009 Instructions for Forms W-2 and W-3.
45. Ibid.
46. IRC §223(d)(2)(C)(ii).
47. IRC §223(d)(2)(B).
48. IRC §223(d)(2)(C).

Question 7. May an HSA tax-free distribution be used to pay for unreimbursed nursing home expenses?

Answer 7. Yes.[49] One of the many attractive features of HSAs is that distributions can be used for many medical expenses that are normally not covered by traditional health insurance plans. These include hearing aids, dental care, vision care, and chiropractic services.

Conclusion. See the following for more information regarding HSAs:

- IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*
- IRS Notice 2008-59 (42 detailed questions and answers concerning many HSA tax issues)[50]
- IRS Notice 2008-51[51]
- IRS Notice 2008-52[52]
- Pages 5–18 in the 2005 *University of Illinois Federal Tax Workbook*
- Pages 15–22 in the 2007 *University of Illinois Federal Tax Workbook*

> **Note.** The last two items are available on the accompanying CD.

PROBLEM 4: LOSSES

CASUAL SLOT MACHINE GAMBLING WINNINGS AND LOSSES

In late 2008, the IRS issued advice concerning how a casual gambler determines wagering winnings and losses from **slot-machine** play.[53] Following are the conclusions of this advice:

1. Winnings or losses must be computed on a daily basis.
2. The days with net winnings are **not** combined with days of net losses to determine an annual net winnings or net losses figure.
3. The two sources of authority for the conclusions reached in the advice are:
    - A decision of the 9th Circuit Court regarding a compulsive gambler,[54] and
    - Rev. Rul. 83-103.[55]

> **Note.** Chief Counsel Advice (CCA) guidance is the opinion of the IRS. It pertains to how a certain portion of the Internal Revenue Code should be interpreted. This particular CCA was issued in response to "a recurring issue in litigation." CCAs are near the bottom of the substantial-authority ladder.

49. IRC §223(d)(2)(A). See also IRC §213(d)(1)(C).
50. IRS Notice 2008-59, 2008-29 IRB 123 (July 21, 2008).
51. IRS Notice 2008-51, 2008-25 IRB 1163 (June 23, 2008).
52. IRS Notice 2008-52, 2008-25 IRB 1166 (June 23, 2008).
53. Chief Counsel Advice AM 2008-011 (Dec. 12, 2008).
54. *U.S. v. William L. Scholl*, F.3d 964 (9th Cir. 1999), *aff'g* an unreported District Court decision.
55. Rev. Rul. 83-103, 1983-2 CB 148.

Example 11. Maureen, a methodical and frugal gambler, frequents the local casino seeking fame and fortune (mainly the latter) from playing slot machines. Since 25 is her lucky number, she visited the casino 10 days in 2009, on the 25th of each month except June and July. Since she is retired and on a fixed income, she limits her daily gambling losses to $100.

On each of her 10 visits to the casino in 2009, she exchanged $100 of cash for $100 of slot-machine tokens. Following is a recap of each day's net winnings and losses:

1. On five of the days, she lost her entire $100 in tokens, quit, and returned home.
2. On the other five days, she redeemed her remaining tokens for the following amounts of cash:

25th Day of…	Amount of Cash Redeemed	Net Daily Losses	Net Daily Winnings
March	$ 20	($ 80)	N/A
May	70	(30)	N/A
August	150	N/A	$ 50
October	200	N/A	100
November	300	N/A	200
Net winnings or losses for these 5 days		**($110)**	**$350**
Losses for 5 days when she lost all $100		**(500)**	**N/A**
Net winnings or losses for the 10 days		**($610)**	**$350**

If Maureen combines her net daily winnings (+$350) and her net daily losses (–$610), her net slot machine gambling loss for 2009 is $260 ($610 of losses – $350 of winnings). She wants to know the correct way to report the slot machine winnings and losses on her 2009 Form 1040.

Correct Tax Result per the IRS Advice. If Maureen follows the IRS advice, she reports the following on her 2009 Form 1040:

- $350 of winnings on line 21 (Other income) of her Form 1040.
- If she itemizes, she can deduct $350 of gambling losses on line 28 (Other miscellaneous deductions) of her Schedule A, *Itemized Deductions*. This deduction is not subject to the 2% limitation.
- If she does not itemize, which is likely, she **still** must report the $350 of winnings as gross income.[56]

Observations

1. This advice contains a more lenient interpretation than previous IRS analysis which seemed to call for a **per bet** or **per machine** computation of net gains.[57]
2. Taxpayers using this method must keep complete and credible logs and other documentation to support the entries on their returns.
3. This advice could be used as the basis for an argument to include in AGI **less than the total winnings reported on the Forms W-2G**, *Certain Gambling Winnings*. For example, a gambler will receive a W-2G for slot machine winnings of $1,200 or more. However, few gamblers actually leave the casino with that much profit for the day. This advice would allow the taxpayer to report only that day's winnings, if any, instead of the full jackpot.

Caution. If the winnings reported by the taxpayer on the return are less than the total of the Forms W-2G issued to the taxpayer, the IRS will issue a CP-2000, *Notice of Unreported Income*, and bill the taxpayer for additional taxes based on the Form W-2G amounts. Practitioners should be confident in the taxpayer's documentation and be prepared to defend the method used to calculate net winnings.

56. Rev. Rul. 54-339, 1954-2 CB 89.

57. Rev. Proc. 77-29, 1977-2 CB 538.

4. Many casual gamblers do not report any winnings unless they receive a Form W-2G.
5. The rationale of this advice could logically be applied to other types of gambling such as betting on horses or dog races.
6. Reported gambling winnings increase AGI, which can result in tax effects such as:
   - Reduced medical expense deductions,
   - Reduced miscellaneous itemized deductions,
   - Increased taxable social security benefits,
   - Phased out tax credits, such as education credits, and
   - Creation of AMT liability.

Note. See pages 38–42 in the 2003 *University of Illinois Federal Tax Workbook* for more information regarding gambling winnings and losses, especially documentation of losses. Past workbooks can be found online at **www.taxschool.illinois.edu/taxbookarchive.**

REAL ESTATE PROFESSIONAL EXCEPTION TO PASSIVE LOSS LIMITATION RULES

A 2009 Tax Court decision involved a dispute over whether the activities of a **licensed real estate agent** qualify for the real estate professional exception to the passive loss rules.[58] The decision received considerable coverage by numerous tax information reporting sources.

The dispute centered on a technical interpretation of whether a real estate agent qualifies as a real estate "broker" under IRC §469.[59] The *Agarwal* Tax Court decision held that the answer to that question was **yes.** Therefore, this decision is important for thousands of licensed real estate agents nationwide who own and manage their own rental properties in addition to conducting their normal agent duties. Using the rationale of this decision, they can now potentially qualify for a full deduction of their Schedule E nonpassive rental losses.

Following is an analysis of the *Agarwal* Tax Court decision.

Facts. During 2001 and 2002, Mr. Agarwal worked full-time as an engineer. Mrs. Agarwal worked full-time as a real estate agent at a California Century 21 brokerage firm. She was licensed as a real estate agent under California law, but she was not licensed as a broker. Her contract with Century 21 required her to "sell, exchange, lease, or rent properties and solicit additional listings, clients, and customers diligently and with her best efforts."

During 2001 and 2002, the taxpayers owned two rental properties. Together they spent approximately 170 hours managing Property #1 and 170 hours managing Property #2. They were the only ones who provided management services for their two rental properties. Mrs. Agarwal spent a total of 1,400 hours in 2001 and 1,600 hours in 2002 managing the rental properties and performing her duties for Century 21.

The taxpayers reported and deducted the following Schedule E rental losses:

Year	Schedule E Rental Loss Reported and Deducted
2001	($40,104)
2002	(19,656)

58. *Shri G. and Sudha Agarwal v. Comm'r*, TC Summ. Op. 2009-29 (Mar. 2, 2009).

59. IRC §469(c)(7)(C).

In its examination, the IRS disallowed the Schedule E losses for each year because the losses were in excess of:

- Their passive income, and
- The special allowance for rental real estate activities with active participation (computed in Part II of Form 8582, *Passive Activity Loss Limitations*).

Issue. Whether the taxpayers are entitled to deduct the Schedule E rental losses in full as qualifying taxpayers who are in **real property trades or businesses.**[60]

> **Note.** The IRS apparently agreed that Mrs. Agarwal spent the required 750 hours or more each year managing the two rental properties and performing her Century 21 duties.[61] In other words, she met the material participation test[62] **if** the Tax Court determined that a real estate agent's duties qualified as being "performed in real property trades or businesses."[63]

Analysis. IRC §469(c)(7)(C) defines the term "real property trade or business" as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or **brokerage** trade or business" (emphasis added).

The IRS argued that Mrs. Agarwal was a licensed real estate agent, not a licensed real estate broker. Since California law distinguished the two, she was not engaged in a **brokerage** trade or business and therefore did not meet the IRC §469(c)(7)(C) "brokerage" definition.

Holding. The Tax Court disagreed with the IRS's narrow interpretation. It concluded that Congress presumed to define the term "brokerage" in its common or ordinary meaning. It further concluded that for purposes of IRC §469 (the passive activity loss limitations), the "business" of a real estate broker includes the duties normally performed by a real estate agent. **Therefore, the Schedule E rental losses for 2001 and 2002 were allowed in full under the real estate professional exception.**

> **Note.** Real estate activities of qualifying real estate professionals are not considered passive activities and should not be included on Form 8582. See pages 34–41 in the 2004 *University of Illinois Federal Tax Workbook* for more information on this issue. Past workbooks can be found online at **www.taxschool.illinois.edu/taxbookarchive.**

ABANDONMENT LOSSES

Background Information

In today's difficult economy, more taxpayers may decide to abandon a planned business venture rather than pursue it to completion. Various factors may lead a taxpayer to abandon a planned business venture, including the following:

- Financing may not be available in the current tight credit market.
- A taxpayer may decide it is too risky to commit more dollars (usually borrowed) and time to a new business venture.
- What previously seemed like a wonderful business opportunity is simply a bad idea under current economic conditions.
- Personal circumstances of the taxpayer changed for the worse.

60. IRC §469(c)(7)(C).
61. IRC §469(c)(7)(B)(ii).
62. IRC §469(c)(7)(B).
63. IRC §469(c)(7)(C).

Definition of Abandonment

The abandonment of property is a disposition of property. It occurs when a taxpayer voluntarily and permanently gives up possession and use of property with the intention of ending ownership of it but without passing it on to anyone else.[64]

Deduction of Abandonment Losses

Loss from abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset.[65]

> **Note.** The term "abandonment loss" is not found in either IRC §165 or its related Treasury Regulations. The theory of such losses has been developed and explained by various court decisions.

The authority for deducting abandonment losses is IRC §165. The pertinent portions of §165 are analyzed below:

1. IRC §165(a) allows as a deduction "any loss sustained during the taxable year and not compensated for by insurance or otherwise." In other words, the loss must involve a completed transaction that is closed by the end of the taxable year. In addition, the loss must be uncompensated.[66]
2. IRC §165(b) provides that "the basis for determining the amount of the deduction for any loss shall be the adjusted basis" of the abandoned property.
3. IRC §165(c) places restrictions on losses of individuals. Three types of losses are allowed to individual taxpayers:
   - Losses incurred in a trade or business
   - Losses incurred in any transaction entered into for profit, though not connected with a trade or business
   - Casualty and theft losses (reportable on Form 4684, *Casualties and Thefts,* which flows to Schedule A)

> **Note.** A **business abandonment loss** is claimed in Part II of Form 4797, *Sales of Business Property,* and is fully deductible in arriving at AGI. An existing business might be abandoned if no buyer can be found for it. In that case, the owner simply walks away and forgoes future attempts to sell any assets of the abandoned business. However, an existing business is less likely to be abandoned than a planned future business venture.

A 2009 Tax Court case demonstrates the requirements for individuals to claim an abandonment loss incurred in a trade or business.[67] The court case is analyzed below.

Facts. The taxpayers paid a $25,000 nonrefundable franchise fee to Quiznos Franchising, LLC (Quiznos) in October 2003, with the intent to open a Quiznos restaurant. The franchise agreement stated that the taxpayers would execute a lease for a restaurant location within one year from the date the agreement was signed.

After diligent investigation, the taxpayers learned that many of the restaurants of other franchise owners were unprofitable. Therefore, they decided to abandon their business venture and requested a refund of the previously-paid franchise fee. After dealing with many unanswered letters to Quiznos, the taxpayers contacted the Minnesota Attorney General in 2005. However, all attempts to secure a refund proved unsuccessful as of December 31, 2005. The taxpayers did not pursue the matter further because they could not afford an attorney.

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64. IRS Pub. 544, *Sales and Other Dispositions of Assets,* p. 4 (2008).
65. Ibid.
66. Treas. Regs. §§1.165-1 (a) and (b).
67. *Abdasslam and Susan Alami El Moujahid v. Comm'r,* TC Memo 2009-42 (Feb. 23, 2009).

The taxpayers claimed a business abandonment loss on their 2005 joint tax return. The amount of the claimed abandonment loss was $25,750, consisting of the $25,000 franchise fee plus $750 they paid to incorporate. The IRS disallowed the entire loss because the taxpayers had taken no action by the end of 2005 to formally dissolve the corporation the taxpayers had formed to operate the restaurant.

Holding. The Tax Court determined that the taxpayers "actually abandoned their Quiznos franchise by the end of 2005" for the following reasons:

- They repeatedly expressed to Quiznos that they had decided to discontinue their efforts to open a restaurant.
- They did not select a restaurant location within the 1-year limit mentioned in the franchise agreement.
- They did not contribute the additional money needed to open a restaurant.
- Even though the taxpayers' corporation had not been dissolved as of the end of 2005, they abandoned it when they abandoned the franchise. It ceased to be of use to them once they abandoned their Quiznos franchise.

As a result, the court held that the taxpayers were entitled to deduct the $25,750 business-related abandonment loss reported in Part II on their 2005 Form 4797.

> **Note.** See page 391 in the 2008 *University of Illinois Federal Tax Workbook* for more information on abandoning franchise businesses. This can be found on the accompanying CD.

PONZI SCHEME LOSSES

Background Information

Many taxpayers have been victimized by fraudulent investment schemes, including a Ponzi scheme operated by Bernard Madoff. He was arrested by federal authorities on December 11, 2008, and charged with securities fraud. His victims lost an estimated $65 billion through investing with Bernard L. Madoff Investment Securities, LLC (BMIS).[68]

In addition to stealing their money, BMIS reported fictitious earnings to the IRS on the annual tax-reporting statements for its investors.[69] This erroneous tax-reporting information caused the investors to overpay their taxes. According to at least one analyst, defrauded investors may be due refunds of nearly $17 billion.[70]

Other Ponzi schemes have been discovered by federal authorities during 2009, including:

- **Allen Stanford's $7 billion fraudulent certificate of deposit scheme.** Allen Stanford surrendered to the FBI on June 18, 2009, after his indictment by the U.S. Justice Department on wire fraud, mail fraud, and conspiracy to commit securities fraud.[71]
- **Lancelot Investment Management (LIM) and its owner, Gregory Bell.** LIM, a hedge-fund firm located in Northbrook, Illinois, and Mr. Bell, were charged by the Securities and Exchange Commission on July 10, 2009.[72]

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68. *The Madoff Case: A Timeline.* Mar. 12, 2009. *The Wall Street Journal*. [online.wsj.com/article/SB112966954231272304.html] Accessed on June 10, 2009.

69. Lifson, D. A. (2009, May). After the Fraud: For Victims of Ponzi Schemes Like the Infamous Mr. Madoff's, There Are Some Tax Recovery Tools Available. *Investment Advisor,* 48–53.

70. *Madoff's Alleged Scheme Could Cost IRS up to $17B in Lost Tax Revenue.* Dec. 18, 2008. Fox News. [www.foxnews.com/story/0,2933,469825,00.html] Accessed on June 10, 2009.

71. Billionaire is jailed, charged with fraud. (June 20, 2009). *The Chicago Tribune,* p. 11, Section 1.

72. Hughlett, M. (July 11, 2009). Firm part of Ponzi scheme, SEC says. *The Chicago Tribune,* p. 12, Section 1.

In March 2009, the IRS issued guidance to taxpayers victimized by criminally fraudulent Ponzi schemes, including the one perpetrated by BMIS. The guidance is provided in two sources:

- Rev. Rul. 2009-9[73]
- Rev. Proc. 2009-20[74]

> **Note.** The IRS guidance is very taxpayer friendly and could result in huge theft-loss deductions and resulting net operating loss (NOL) carrybacks for individual taxpayers victimized by Ponzi schemes perpetrated by BMIS and other criminal entities.

Key Issues Addressed in Rev. Rul. 2009-9

Issue 1. Whether a loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss[75] or a capital loss.[76]

Issue 2. Whether such loss is subject to the "personal" casualty and theft-loss limitations and the reduction in allowable itemized deductions for high-income taxpayers. These limitations are:

- The 10% of AGI reduction for net casualty and theft losses for the year.[77]
- The total of itemized deductions is reduced for high-income taxpayers based on a percentage of AGI.[78]
- The $500 limitation for each casualty or theft loss.[79]

> **Note.** For 2009 only, the usual $100 limitation increases to $500 and then reverts to $100 for years after 2009.

Issue 3. In what year is such a loss deductible?

Issue 4. How is the amount of such a loss calculated?

The ruling also reached the following procedural conclusions:

1. An investment-related theft loss may create or increase an NOL that can be carried back up to three years and forward up to 20 years. For 2008, an individual may elect a 3-, 4-, or 5-year NOL carryback.
2. An investment-related theft loss does not qualify for a refund of taxes under claim of right.[80]
3. An investment-related theft loss does not qualify for the mitigation provisions of IRC §§1311–1314 to correct errors made in closed years.

73. Rev. Rul. 2009-9, 2009-14 IRB 735 (Apr. 6, 2009).
74. Rev. Proc. 2009-20, 2009-14 IRB 749 (Apr. 6, 2009).
75. IRC §165(c)(3) .
76. IRC §1211.
77. IRC §165(h)(2).
78. IRC §68.
79. IRC §165(h)(1).
80. IRC §1341.

Guidance Provided in Rev. Rul. 2009-9

Issue 1: Theft Loss. For federal income tax purposes, the term "theft" means any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses, and other form of guile.[81] A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was:

- Illegal under the law of jurisdiction in which it occurred, and
- Done with criminal intent.[82]

> **Caution.** A loss sustained on the worthlessness or sale of stock acquired on the open market for investment is a capital loss and not a theft loss. This is true even if the stock's decline in value is due to fraudulent activities of the corporation's officers or directors.[83] Recent examples include investors who were Enron and WorldCom shareholders.

Conclusion for Issue 1. Individual taxpayers victimized by Ponzi schemes perpetrated by Mr. Madoff and other criminals qualify for a theft-loss deduction on their income tax returns as opposed to a capital loss. Therefore, their loss is not limited to $3,000 in excess of capital gains in the initial year of the theft.

Issue 2: Deduction Limitations. The three limitations listed in Issue 2 above do **not** apply to losses connected with a trade or business or **a transaction entered into for profit.**[84] The victims opened the investment accounts with the perpetrators with the intent of earning profits (albeit unreasonably high profits).

Conclusion for Issue 2. Individual taxpayers victimized by Ponzi schemes perpetrated by BMIS and other criminal entities are not subject to the $100/$500 + 10% of AGI reductions that normally apply to personal casualty and theft losses. In addition, their theft losses are not subject to the reduction in total itemized deductions that can apply to high-income individuals.

Issue 3: Year of Deduction. A theft loss is realized for deduction purposes during the tax year in which the taxpayer **discovers** the loss.[85] However, if a taxpayer expects to be reimbursed for part or all of the loss, the anticipated reimbursement must be subtracted in computing the amount of the loss. This is true even if that reimbursement is not received until a later year.[86]

Conclusion for Issue 3. The year of discovery for individuals victimized by BMIS is **2008,** the year the indictment was filed against Madoff. Therefore, taxpayers victimized by BMIS can claim their initial theft loss on their 2008 tax returns.

> **Caution.** The conclusion for Issue 3 is true **if** the potential future reimbursement from the Security Investor Protection Corporation (SIPC) and/or other sources is **less** than the amount of the actual theft loss.

81. Rev. Rul. 2009-9, citing *Edwards v. Bromberg,* 232 F.2d 107 (5th Cir. 1956) and Treas. Reg. §1.165-8(d).
82. Rev. Rul. 72-112, 1972-1 CB 60.
83. Rev. Rul. 77-17, 1977-1 CB 44.
84. IRC §165(c)(3).
85. IRC §165(e).
86. Treas. Regs. §§1.165-8(a)(2) and 1.165-1(d)(2). See also IRS Pub. 547, *Casualties, Disasters and Thefts* (2008), p. 5.

Issue 4: Amount of Deduction. The amount of an investment theft loss is:

1. The property's basis or money invested, less
2. Any reimbursement or compensation anticipated.

The calculation of a Ponzi scheme investment theft loss is determined using this formula:

	Initial amount invested
+	Additional investments
+	Fictitious investment gains and income reported in gross income in years prior to the year of discovery of the theft loss (if not distributed to the investor)
–	Amounts withdrawn
–	Reimbursements or other compensation actually received
–	Unresolved claims which have a reasonable prospect of future recovery
	Investment theft loss

4

Example 12. Barbara Starlost had the following transactions with Great Ponsi Corp. (GPC) beginning in 2005 and ending in 2008:

Year	Type of Transaction	Transaction Amount	Account Balance
2005	Initial investment	$1,000,000	$1,000,000
2005	Fictitious income reported/credited to account	100,000	1,100,000
2006	Additional investment	$2,000,000	3,100,000
2006	Fictitious income reported/credited to account	200,000	3,300,000
2007	Fictitious income reported/credited to account	200,000	3,500,000
2008	Cash withdrawn in May 2008 for cosmetic surgery	(500,000)	3,000,000

When Barbara tried to withdraw the $3 million balance in October 2008, employees of GPC told her repeatedly that the check was in the mail. However, she never received the $3 million. GPC's owner, Mr. MadeMuch, was indicted for securities fraud in November 2008. His firm subsequently filed for bankruptcy.

Her attorney filed a claim in March 2009 for reimbursement with the trustee appointed by the Bankruptcy Court to oversee the liquidation of the assets of Mr. MadeMuch's investment firm and related entities. Her attorney told Barbara she can expect to receive approximately $500,000 from the trustee at an unknown future date.

Note. The $500,000 expected future recovery represents the anticipated advance from the Security Investor Protection Corporation (SIPC). The maximum SIPC advance payment to an individual customer of a securities firm on account of missing securities is $500,000.

Tax Solution. According to Rev. Rul. 2009-9, Barbara's loss for her investment in the Ponzi scheme is $2.5 million computed as follows:

Investment in the account as of December 31, 2008	$3,000,000
Less: the expected future recovery	(500,000)
Amount of Barbara's theft loss	$2,500,000

The year of discovery is 2008, the year the GPC fraud became known. Therefore, Barbara has a $2.5 million theft loss for 2008.

Assume the following for 2008:

- The $2.5 million theft loss created an NOL for Barbara in 2008.
- Barbara's average AGI for the 3-year period 2005 through 2007 does not exceed $15 million.

Due to a provision in the American Recovery and Reinvestment Act of 2009, Barbara may elect to carry back the 2008 loss three, four, or five years.[87]

Note. See Chapter 7, Net Operating Losses, for information on the rules for carrybacks of 2008 NOLs.

Caution. Rev. Rul. 2009-9 does not address the possibility of amending the returns for open years in which income was overstated. If this tactic is used, the method of calculating the loss as described in Issue 4 must be adjusted accordingly. **In addition, the safe-harbor procedure, discussed next, is conditioned on the taxpayers not amending prior year returns to claim refunds related to the theft loss.[88]**

GUIDANCE PROVIDED IN REV. PROC. 2009-20

Background Information

The IRS and Treasury Department recognize that determining if and when investors meet the requirements for claiming a theft loss for an investment in a Ponzi scheme is difficult. Often, the facts are not clear in the year the loss is discovered.

This Revenue Procedure provides an **optional safe harbor** under which qualified investors may treat a loss as a theft-loss deduction. This treatment provides qualified investors with a uniform manner for determining their theft losses. In addition, this treatment avoids potentially difficult problems of proof in determining how much income reported in prior years was fictitious or a return of capital and alleviates compliance and administrative burdens on both taxpayers and the IRS.

87. IRC §172(b)(1)(H). This provision applies to individuals sustaining investment-related theft losses as if the individual is a small business. Section 172(d)(4)(C) (pertaining to NOLs) treats any deduction for casualty or theft losses under §165(c)(2) or (3) (pertaining to businesses and transactions entered into for profit) as a business deduction.

88. *Commissioner Shulman's Senate Finance Testimony on Ponzi Schemes and Offshore Tax Evasion Legislation*. Mar. 17, 2009. [www.irs.gov/newsroom/article/0,,id=205374,00.html] Accessed on June 11, 2009.

KEY ISSUES ADDRESSED IN REV. PROC. 2009-20

1. Only a **qualified investor** can use the optional safe-harbor rules. The following are qualified investors:[89]
   - A citizen or a resident of the United States
   - A domestic partnership
   - A domestic corporation
   - Any estate (other than a foreign estate)
   - Any trust under U.S. court jurisdiction with one or more U.S. persons having authority over the trust

   For purposes of this revenue procedure, a qualified investor does **not** include an individual who invested solely in a fund that invested in the fraudulent arrangement. Therefore, an investor who participated in a Ponzi scheme through a **feeder fund** is not a qualified investor. However, the fund itself may be a qualified investor.

2. The **qualified investment** is generally computed in the same manner shown in **Example 12** for Barbara Starlost. Investments deposited into feeder funds are not part of the qualified investment.

3. The formula for computing the safe-harbor deductible theft loss depends on whether the qualified investor is suing persons other than the lead promoter.

   Rule for Qualified Investors Who Are NOT Suing Persons Other Than the Lead Promoter(s). The taxpayer is entitled to deduct **95%** of the qualified investment less these specific recoveries:

   a. Actual recovery in the year of discovery

   b. Expected recovery from private insurance and from the SIPC

   Rule for Qualified Investors Who ARE Suing Persons Other Than the Lead Promoter(s). The taxpayer is entitled to deduct **75%** of the qualified investment less the recoveries shown above.

4. Taxpayers must use the worksheet found in Appendix A of Rev. Proc. 2009-20 (shown on the following pages) as an attachment to the return for the year the theft loss is deducted (the year of discovery).

4

[89] IRC §7701(a)(30).

APPENDIX A

Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement

Part 1. Identification

1. Name of Taxpayer ____

2. Taxpayer Identification Number ___________________________________

Part II. Computation of deduction

(See Rev. Proc. 2009-20 for the definitions of the terms used in this worksheet.)

Line	Computation of Deductible Theft Loss Pursuant to Rev. Proc. 2009-20		
1	Initial investment		
2	Plus: Subsequent investments		
3	Plus: Income reported in prior years		
4	Less: Withdrawals	( )	
5	Total qualified investment (combine lines 1 through 4)		
6	Percentage of qualified investment (95% of line 5 for investors with no potential third-party recovery; 75% of line 5 for investors with potential third-party recovery)		
7	Actual recovery		
8	Potential insurance/SIPC recovery		
9	Total recoveries (add lines 7 and 8)		( )
10	Deductible theft loss (line 6 minus line 9)		

Part III. Required statements and declarations

1. I am claiming a theft loss deduction pursuant to Rev. Proc. 2009-20 from a specified fraudulent arrangement conducted by the following individual or entity (provide the name, address, and taxpayer identification number (if known)).

____

2 I have written documentation to support the amounts reported in Part II of this document.

3. I am a qualified investor as defined in § 4.03 of Rev. Proc. 2009-20.

4. If I have determined the amount of my theft loss deduction under § 5.02(1)(a) of Rev. Proc. 2009-20, I declare that I have not pursued and do not intend to

pursue any potential third-party recovery, as that term is defined in § 4.10 of Rev. Proc. 2009-20.

5. If I have already filed a return or amended return that does not satisfy the conditions in § 6.02 of Rev. Proc 2009-20, I agree to all adjustments or actions that are necessary to comply with those conditions. The tax year or years for which I filed the return(s) or amended return(s) and the date(s) on which they were filed are as follows:

____
____
____
____

Part IV. Signature

I make the following agreements and declarations:

1. I agree to comply with the conditions and agreements set forth in Rev. Proc. 2009-20 and this document.

2. Under penalties of perjury, I declare that the information provided in Parts I-III of this document is, to the best of my knowledge and belief, true, correct and complete.

Your signature here ________________________ Date signed: _______
Your spouse's signature here ____________________ Date signed: ______

Corporate Name _______________________________
Corporate Officer's signature __________________________
Title __________________________
Date signed ________

Entity Name ____
S-corporation, Partnership, Limited Liability Company, Trust
Entity Officer's signature ____________________________________
Date signed ___________

Signature of executor ____
Date signed ____

Instructions for the Completed Worksheet

1. The amount of the "deductible theft loss" from line 10 of the worksheet is entered on line 34, section B, Part I of Form 4684, *Casualties and Thefts,* and attached to the tax return for the discovery year. The remainder of Part I is not completed.
2. "Revenue Procedure 2009-20" is written at the top of Form 4684.
3. The loss on Form 4684 is carried to line 28, "Other miscellaneous deductions," on Schedule A.
4. The taxpayer must complete and sign the statement (page 2, Appendix A) and attach the 2-page Appendix A to the tax return for the discovery year.

By signing the statement in Appendix A, the taxpayer agrees:

- **Not** to file amended returns to exclude or recharacterize any income reported by the fraudulent Ponzi investment scheme in tax years **preceding** the discovery year (the year of the allowable theft loss).
- **Not** to use the mitigation provisions of IRC §§1311–1314 or §1341 regarding any income (fictitious or real) that was incorrectly reported in prior tax years that are otherwise barred by the time limitations for filing an amended return or claim for refund authorized by IRC §6511.

> **Note.** If the amounts of the recoveries received exceed the projected amounts based on the safe-harbor calculation, the taxpayer must report the excess as income in the year received. On the other hand, if the recoveries are less than the projected amounts, the taxpayer may claim an additional deduction in the year that the remedies are exhausted.

PROBLEM 5: MORTGAGE CREDIT CERTIFICATES (FORM 8396)

BACKGROUND INFORMATION

The mortgage interest credit is intended to help lower-income individuals afford home ownership. The credit was added to the Internal Revenue Code by Congress in 1984.[90] The credit is claimed **each** year for a portion of the home mortgage interest paid during the year.

Due to the dramatic decrease in housing prices, many lower-income taxpayers who were renting may now be able to afford the purchase of a principal residence. However, lenders instituted tough new conditions on prospective home buyers. The days of "liar loans" and unscrupulous mortgage brokers ended due to the subprime mortgage crisis which triggered the current economic downturn. As a result, many lower-income taxpayers find that they are unable to secure financing to fulfill their goal to attain home ownership. For those that do, mortgage credit certificates could be very beneficial.

WHO QUALIFIES FOR THE CREDIT?

An individual who was issued a mortgage credit certificate (MCC) by a **state or local governmental unit or agency** may qualify for the credit. The related mortgage must be for acquisition, rehabilitation, or improvement of the taxpayer's main home.[91] The home to which the MCC relates must meet three tests:[92]

1. It must be the individual's principal residence.
2. The residence must be a one-unit property, such as a single-family home, a condo, or a town home.
3. It must be located in the jurisdiction of the governmental unit that issued the certificate.

> **Note.** The Illinois Housing Development Authority (IHDA) administers the federally-authorized MCC program for the state of Illinois. Other states have similar housing authorities. MCCs are issued by IHDA on a first-come, first-served basis as funds become available for a particular community. For more information on the programs available, target areas, requirements, and income and price limits by county in Illinois see **www.ihda.org.**

90. IRC §25, Interest on Certain Home Mortgages.
91. IRC §25(c)(1)(B).
92. Temp. Treas. Reg. §1.25-3T(d).

Requirements for Securing a Qualified Mortgage Credit Certificate. The following conditions apply to individuals seeking an MCC:[93]

1. The borrower (and his spouse, if applicable) must be **first-time homebuyers.** A first-time homebuyer is defined as someone who has not owned a principal residence within the last three years.
2. The following borrowers are **exempt** from the first-time-homeowner requirement:
   - Those who buy in any **targeted area**
   - Veterans and their spouses
   - Those issued MCCs under a program to improve or rehabilitate their homes
3. The mortgage loan must be a new mortgage loan or a qualified refinancing.[94]
4. The household must meet certain income limits, and the home must meet purchase price limits. Those limits are determined by the county in which the homes are purchased.

A prospective qualified individual must secure the MCC **before** obtaining a mortgage. Participating lenders and Community Housing Development Organizations will assist the prospective buyer in obtaining the certificate.

HOW TO COMPUTE AND CLAIM THE CREDIT

The nonrefundable credit is claimed on Form 8396, *Mortgage Interest Credit*.

The credit is a percentage of the annual mortgage interest paid, usually no more than 20%. The credit rate is stated on the certificate. The amount of the credit must be subtracted from mortgage interest paid to determine the amount of mortgage interest that qualifies as an itemized deduction on Schedule A, line 10.[95]

Any credit not used in the current year may be carried forward to the next three years.[96]

Example 13. Wanda, a 60-year-old widow, has rented an apartment for the last four years. Her 2009 income of $56,000 is below the income limit of $74,200[97] for one-member households set by the IHDA for DeKalb County, Illinois. She buys a single-family residence in the county seat of Sycamore, Illinois, on June 1, 2009, for $70,000. This is well below the purchase price limit of $349,020[98] set by the IHDA for DeKalb County.

Her mortgage broker helped her obtain a mortgage credit certificate. The MCC included:

- A certificate credit rate of 20%, and
- A certified loan amount of $63,000. She made a down payment of $7,000 with funds remaining from the assets she inherited from her deceased husband.

The lender's interest rate for her 30-year $63,000 mortgage is 4.75%. Her 2009 Form 1098, *Mortgage Interest Statement*, reports $1,500 of interest paid. Her 2009 Forms 1040 and 8396 are shown next.

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93. *I-Loan Certificate (MCC) Programs.* Illinois Housing Development Authority. [www.ihda.org/ViewPage.aspx?PageID=27] Accessed on June 12, 2009.

94. Treas. Reg. §1.125-3(p).

95. IRC §163(g).

96. IRC §25(e)(1)(A).

97. *Non-Targeted Areas Income & Purchase Price Limits Effective 4/6/2009.* Illinois Housing Development Authority. [www.ihda.org/admin/Upload/Files//21221161-0482-4622-8fba-82f93494a03e.pdf] Accessed on June 12, 2009.

98. Ibid.

For Example 13

Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2009 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2009, or other tax year beginning , 2009, ending , 20 OMB No. 1545-0074

Label (See instructions on page 14.) **Use the IRS label.** Otherwise, please print or type. LABEL HERE

Your first name and initial: **Wanda** Last name: **Brooks** Your social security number: **111 22 3333**

If a joint return, spouse's first name and initial | Last name | Spouse's social security number

Home address (number and street). If you have a P.O. box, see page 14. **318 Oak St.** Apt. no.

▲ You **must** enter your SSN(s) above. ▲

City, town or post office, state, and ZIP code. If you have a foreign address, see page 14. **Sycamore, IL 60178**

Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 14) ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 16)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a — Boxes checked on 6a and 6b: **1**
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 17)
			☐
			☐
			☐
			☐

If more than four dependents, see page 17 and check here ▶ ☐

No. of children on 6c who: • lived with you • did not live with you due to divorce or separation (see page 18) Dependents on 6c not entered above

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

Income

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

If you did not get a W-2, see page 22.

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

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	42,000
8a	**Taxable** interest. Attach Schedule B if required	8a	1,000
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 22) — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23)	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 24)	15b	
16a	Pensions and annuities — 16a — b Taxable amount (see page 25)	16b	13,000
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 in excess of $2,400 per recipient (see page 27)	19	
20a	Social security benefits — 20a — b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	56,000

Adjusted Gross Income

23	Educator expenses (see page 29)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see page 30)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction (see page 31)	32	
33	Student loan interest deduction (see page 34)	33	
34	Tuition and fees deduction. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35	36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶	37	56,000

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 87. Cat. No. 11320B Form **1040** (2009)

For Example 13

Form 1040 (2009) Page **2**

Tax and Credits	38	Amount from line 37 (adjusted gross income)			38	56,000
	39a	Check if: { ☐ **You** were born before January 2, 1945, ☐ Blind. / ☐ **Spouse** was born before January 2, 1945, ☐ Blind. } **Total boxes checked** ▶ 39a ☐				
Standard Deduction for— • People who check any box on line 39a, 39b, or 40b **or** who can be claimed as a dependent, see page 35. • All others: Single or Married filing separately, $5,700 Married filing jointly or Qualifying widow(er), $11,400 Head of household, $8,350	b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here ▶ 39b ☐				
	40a	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40a	5,700
	b	If you are increasing your standard deduction by certain real estate taxes, new motor vehicle taxes, or a net disaster loss, attach Schedule L and check here (see page 35) ▶ 40b ☐				
	41	Subtract line 40a from line 38			41	50,300
	42	**Exemptions.** If line 38 is $125,100 or less and you did not provide housing to a Midwestern displaced individual, multiply $3,650 by the number on line 6d. Otherwise, see page 37			42	3,650
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	46,650
	44	**Tax** (see page 37). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972			44	7,856
	45	**Alternative minimum tax** (see page 40). Attach Form 6251			45	
	46	Add lines 44 and 45 ▶			46	7,856
	47	Foreign tax credit. Attach Form 1116 if required	47			
	48	Credit for child and dependent care expenses. Attach Form 2441	48			
	49	Education credits from Form 8863, line 29	49			
	50	Retirement savings contributions credit. Attach Form 8880	50			
	51	Child tax credit (see page 42)	51			
	52	Credits from Form: a ☑ 8396 b ☐ 8839 c ☐ 5695	52	300		
	53	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	53			
	54	Add lines 47 through 53. These are your **total credits**			54	300
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶			55	7,556
Other Taxes	56	Self-employment tax. Attach Schedule SE			56	
	57	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919			57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			58	
	59	Additional taxes: a ☐ AEIC payments b ☐ Household employment taxes. Attach Schedule H			59	
	60	Add lines 55 through 59. This is your **total tax** ▶			60	7,556
	61	Federal income tax withheld from Forms W-2 and 1099	61			

4

For Example 13

Form **8396**
Department of the Treasury
Internal Revenue Service (99)

Mortgage Interest Credit

(For Holders of Qualified Mortgage Credit Certificates Issued by State or Local Governmental Units or Agencies)

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

OMB No. 1545-0074
2009
Attachment Sequence No. 138

Name(s) shown on your tax return	Your social security number
Wanda Brooks	111-22-3333

Enter the address of your main home to which the qualified mortgage certificate relates if it is different from the address shown on your tax return.

Name of Issuer of Mortgage Credit Certificate	Mortgage Credit Certificate Number	Issue Date

Before you begin Part I, figure the amounts of any of the following credits you are claiming: Credit for the elderly or the disabled, alternative motor vehicle credit, qualified plug-in electric vehicle credit, and qualified plug-in electric drive motor vehicle credit.

Part I Current Year Mortgage Interest Credit

1	Interest paid on the certified indebtedness amount. If someone else (other than your spouse if filing jointly) also held an interest in the home, enter only your share of the interest paid	1	1,500
2	Enter the certificate credit rate shown on your **mortgage credit certificate. Do not** enter the interest rate on your home mortgage	2	20.00 %
3	If line 2 is 20% or less, multiply line 1 by line 2. If line 2 is more than 20%, or you refinanced your mortgage and received a reissued certificate, see the instructions for the amount to enter. **You must reduce your deduction for home mortgage interest on Schedule A (Form 1040) by the amount on line 3.**	3	300
4	Enter any 2006 credit carryforward from line 18 of your 2008 Form 8396	4	
5	Enter any 2007 credit carryforward from line 16 of your 2008 Form 8396	5	
6	Enter any 2008 credit carryforward from line 19 of your 2008 Form 8396	6	
7	Add lines 3 through 6	7	300
8	Enter the amount from Form 1040, line 46, or Form 1040NR, line 43	8	7,856
9	**1040 filers:** Enter the total of the amounts from Form 1040, lines 47 through 50; line 12 of the line 11 Worksheet in Pub. 972 (see instructions); Form 5695, line 11; Form 8834, line 22; Form 8910, line 21; Form 8936, line 14; and Schedule R (Form 1040A or 1040), line 24. **1040NR filers:** Enter the amount from Form 1040NR, lines 44 through 46; line 12 of the line 11 Worksheet in Pub. 972 (see instructions); Form 5695, line 11; Form 8834, line 22; Form 8910, line 21; and Form 8936, line 14.	9	
10	Subtract line 9 from line 8. If zero or less, enter -0- here and on line 11 and go to Part II	10	7,856
11	**Current year mortgage interest credit.** Enter the **smaller** of line 7 or line 10. Also include this amount in the total on Form 1040, line 52, or Form 1040NR, line 48, and check box **a** on that line	11	300

Part II Mortgage Interest Credit Carryforward to 2010. (Complete **only** if line 11 is less than line 7.)

12	Add lines 3 and 4	12	
13	Enter the amount from line 7	13	
14	Enter the **larger** of line 11 or line 12	14	
15	Subtract line 14 from line 13	15	
16	**2008 credit carryforward to 2010.** Enter the **smaller** of line 6 or line 15	16	
17	Subtract line 16 from line 15	17	
18	**2007 credit carryforward to 2010.** Enter the **smaller** of line 5 or line 17	18	
19	**2009 credit carryforward to 2010.** Subtract line 11 from line 3. If zero or less, enter -0-	19	

For Paperwork Reduction Act Notice, see back of form. Cat. No. 62502X Form **8396** (2009)

> **Note.** Certificates issued by the Federal Housing Administration, Department of Veterans Affairs, Farmers Home Administration, and Homestead Staff Exemption Certificates do not qualify for the credit.

Observations.

1. Because Wanda's standard deduction was higher than her itemized deductions, she did not itemize. **If she itemized, her allowable mortgage interest deduction would be $1,200 ($1,500 mortgage interest paid less the $300 credit claimed on line 3 of Form 8396).**

> **Note.** Even if Wanda carried over the entire $300 mortgage interest credit to 2010, she could still deduct only $1,200 of mortgage interest on her 2009 Schedule A.[99]

2. If Wanda's 2009 tax was zero, she could carry over the unused $300 credit to the next three tax years (2010, 2011, and 2012) or until used, whichever comes first. The current year credit is used first and then the prior year credits, beginning with the earliest period.[100]

3. The certificate credit rate cannot be less than 10% or more than 50%.[101] However, the Illinois certificates use the 20% credit rate.[102]

4. **If** the certificate credit rate exceeds 20%, Form 8396, line 3 cannot exceed $2,000.[103] The limit does not apply if the rate is 20% or less.

5. If Wanda sells the home within nine years after the closing date in 2009, she **may** be subject to the recapture rules if the sale results in a gain.[104] This is true even if the gain is eligible for the $250,000 exclusion provided under IRC §121.

Example 14. Wanda, from **Example 13,** sells her home in 2014 and realizes a gain on the sale. At or near the time of settlement of her mortgage loan, she receives a notice that provides the federally-subsidized amount and other information she will need to compute her recapture tax.

Any recapture tax is calculated and reported on Form 8828, *Recapture of Federal Mortgage Subsidy*. Recapture is **not** due if Wanda's 2014 modified AGI is less than the adjusted qualifying income in 2014 for a family of one (related to the income requirements a person must meet to qualify for an MCC).[105] The probability that Wanda will owe a recapture tax in 2014, the year of sale, is low. **However, because she sold the home within nine years, Wanda must include a Form 8828 with her 2014 tax return even if she does not owe a recapture tax.[106]**

> **Note.** See Form 8828 and its instructions for information regarding the complicated potential recapture issue.

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99. General Instructions for 2008 Form 8396.

100. Temp. Treas. Reg. §1.25-2T(d)(2).

101. IRC §25(d)(1).

102. *Loan Certificate (MCC) Programs.* Illinois Housing Development Authority. [www.ihda.org/ViewPage.aspx?PageID=27] Accessed on June 12, 2009.

103. IRC §25(a)(2).

104. IRC §§25(i) and 143(m).

105. IRC §143(m)(4)(E).

106. IRS Pub. 523, *Selling Your Home*, p. 28 (2008).

PROBLEM 6: FORM 1098-T TAX ISSUES

BACKGROUND INFORMATION

The Tax Extenders and AMT Relief Act of 2008 (TEARA) doubled the maximum education credits for students attending colleges in **Midwestern disaster areas.** Then, the American Recovery and Reinvestment Act of 2009 (ARRA) inflated the scope and benefits of the Hope credit, which was rebranded as the **American opportunity credit (AOC)** for 2009 and 2010.

> **Note.** See Chapter 11, New Legislation, for the complete details on the expanded education credits for 2008, 2009, and 2010 tax returns.

Previously, Form 1098-T, *Tuition Statement*, provided inadequate information for proper preparation of the education credits and deduction. This problem is compounded by the changes made by ARRA and TEARA. Two examples are used to help explain some potential problem areas when dealing with this form.

AMERICAN OPPORTUNITY CREDIT FOR 2009 AND 2010

Among other changes, ARRA expanded the definition of qualified tuition and related expenses to include **course materials such as books** for 2009 and 2010.[107] This expansion applies to the AOC, but **not** to the lifetime learning credit or the tuition deduction.

Example 15. Glenda Ames graduated from high school in June 2009, and began her freshman year at Heartland Community College (HCC) in Normal, Illinois, in August 2009. She is a full-time student during both semesters of the 2009–2010 academic year.

She continues to live at her parents' home and they pay all her educational expenses to attend HCC. Her parents, Greg and Ann, claim Glenda's exemption on their joint 2009 tax return. Their 2009 modified AGI is $60,000.

Glenda receives the following 2009 Form 1098-T from HCC.

☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone number
Heartland Community College
Normal, IL 61761
Contact Tel. No. (309)452-0000

1 Payments received for qualified tuition and related expenses $

2 Amounts billed for qualified tuition and related expenses $ **2912.00**

OMB No. 1545-1574

2009

Form **1098-T**

Tuition Statement

FILER'S federal identification no. **37-0000001**

STUDENT'S social security number **012-34-5678**

3 If this box is checked, your educational institution has changed its reporting method for 2009 ☐

Copy B For Student

STUDENT'S name **Glenda Ames**

4 Adjustments made for a prior year $

5 Scholarships or grants $ **891.00**

This is important tax information and is being furnished to the Internal Revenue Service.

Street address (including apt. no.) **1314 Renee Road**

City, state, and ZIP code **Normal, IL 61761**

6 Adjustments to scholarships or grants for a prior year $

7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January - March 2010 ▶ ☒

Service Provider/Acct. No. (see instr.)

8 Checked if at least half-time student ☒

9 Checked if a graduate student ☐

10 Ins. contract reimb./refund $

Form **1098-T** (keep for your records) Department of the Treasury - Internal Revenue Service

[107] IRC §25A(i)(3).

Observations for Glenda's Form 1098-T.

1. The $891 scholarship (box 5) was applied towards the first semester tuition and fees amount of $1,400. Glenda's parents paid $750 in August 2009 for the first semester of the 2009–2010 academic year as shown below:

Tuition paid to HCC ($1,400 – $891 scholarship)	$509
Books paid to Follett's Bookstore	241
Total paid in August 2009	**$750**

2. The box 2 amount of $2,912 consists of two amounts:

First semester tuition and fees (billed in August)	$1,400
Second semester tuition and fees (billed in December)	1,512
Box 2 amount	**$2,912**

3. Box 7 is marked with an "X" because the box 2 amount of $2,912 includes $1,512 billed in December 2009 for the second semester tuition and fees.

4. Since Greg and Ann paid the $1,512 second semester tuition and fees (less any scholarship received by Glenda) in January 2010, that amount is used when preparing their **2010** Form 8863, *Education Credits*.

5. Most colleges send paper Forms 1098-T to students in the mail. However, many abandoned this practice and now make the form available only online. Often, the only way to know in which year the tuition payments were made is to access the account information online. However, the parents do not always have access to the student's online account and many students do not share the missing information with their parents.

6. Students, their parents, and preparers must use caution and avoid assumptions regarding Forms 1098-T.

Tax Result for Example 15. Greg and Ann are entitled to an AOC of $750 on their 2009 Form 8863, *Education Credits*. This form is shown on the following pages.

Observations for Greg and Ann's 2009 AOC.

1. The maximum **2008** AOC for each eligible student was $1,800. The maximum **2009** AOC for each eligible student is $2,500.

2. Their modified AGI of $60,000 (Form 8863, line 11) is well below the increased $160,000 phaseout threshold for high-income joint filers. Therefore, $750 is the allowed AOC.

3. Forty percent ($300) of their $750 AOC is a refundable credit (Form 8863, line 16). The remaining $450 is a nonrefundable credit (Form 8863, line 29).

4. Greg and Ann's 2009 taxable income puts them in the 15% tax bracket and they do not itemize. Therefore, the tuition and fees deduction would result in a tax savings of only $76 ($509 tuition paid × 15%).

For Example 15

Form **8863**

Department of the Treasury Internal Revenue Service (99)

Education Credits (American Opportunity, Hope, and Lifetime Learning Credits)

▶ See separate Instructions to find out if you are eligible to take the credits.

▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074

2009

Attachment Sequence No. 50

Name(s) shown on return	Your social security number
Greg and Ann Ames	344-44-5554

Caution: *You* ***cannot*** *take both an education credit and the tuition and fees deduction (see Form 8917) for the* ***same student*** *for the same year.*

Part I **American Opportunity Credit**

Use Part II if you are claiming the Hope credit for a student attending school in a Midwestern disaster area and elect to waive the computation method in this part for all students.

Caution: *You* ***cannot*** *take the American opportunity credit for more than* ***4*** *tax years for the* ***same student.***

1	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). **Do not** enter more than $4,000 for each student.	(d) Subtract $2,000 from the amount in column (c). If zero or less, enter -0-.	(e) Multiply the amount in column (d) by 25% (.25)	(f) If column (d) is zero, enter the amount from column (c). Otherwise, add $2,000 to the amount in column (e).
	Glenda Ames	012-34-5678	750	0	0	750

2 **Tentative American opportunity credit.** Add the amounts on line 1, column (f). Skip Part II if line 2 is more than zero. If you are taking the lifetime learning credit for a different student, go to Part III; otherwise, go to Part IV . . . ▶ **2** 750

Part II **Hope Credit**

Use this part if you are claiming the Hope credit for a student attending school in a Midwestern disaster area and elect to waive the computation method in Part I for all students.

Caution: *You* ***cannot*** *take the Hope credit for more than* ***2*** *tax years for the* ***same student.***

3	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). **Do not** enter more than $2,400* for each student.	(d) Enter the **smaller** of the amount in column (c) or $1,200**	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)

*For each student who attended an eligible educational institution in a Midwestern disaster area, **do not** enter more than $4,800.

For each student who attended an eligible educational institution in a Midwestern disaster area, enter the **smaller of the amount in column (c) or $2,400.

4 **Tentative Hope credit.** Add the amounts on line 3, column (f). If you are taking the lifetime learning credit for another student, go to Part III; otherwise, go to Part V . . . ▶ **4**

Part III **Lifetime Learning Credit. Caution:** *You* ***cannot*** *take the American opportunity credit or the Hope credit and the lifetime learning credit for the* ***same student*** in the same year.

5	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)

6	Add the amounts on line 5, column (c), and enter the total . . .	6	
7a	Enter the **smaller** of line 6 or $10,000 . . .	7a	
b	For students who attended an eligible educational institution in a Midwestern disaster area, enter the **smaller** of $10,000 or their qualified expenses included on line 6 (see special rules on page 3 of the instructions) .	7b	
c	Subtract line 7b from line 7a . . .	7c	
8a	Multiply line 7b by 40% (.40) . . .	8a	
b	Multiply line 7c by 20% (.20) . . .	8b	
c	**Tentative lifetime learning credit.** Add lines 8a and 8b. If you have an entry on line 2, go to Part IV; otherwise go to Part V	8c	

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 25379M Form **8863** (2009)

For Example 15

Form 8863 (2009) Page 2

Part IV Refundable American Opportunity Credit

9	Enter the amount from line 2			9	750
10	Enter: $180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er)	10	180,000		
11	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	11	60,000		
12	Subtract line 11 from line 10. If zero or less, **stop**; you cannot take any education credit	12	120,000		
13	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	13	20,000		
14	If line 12 is: • Equal to or more than line 13, enter 1.000 on line 14 • Less than line 13, divide line 12 by line 13. Enter the result as a decimal (rounded to at least three places)			14	1.000
15	Multiply line 9 by line 14. **Caution:** If you were under age 24 at the end of the year **and** meet the conditions in the instructions, you cannot take the refundable American opportunity credit. Skip line 16, enter the amount from line 15 on line 17, and check this box ▶ ☐			15	750
16	**Refundable American opportunity credit.** Multiply line 15 by 40% (.40). Enter the amount here and on Form 1040, line 66, or Form 1040A, line 43. Then go to line 17 below			16	300

Part V Nonrefundable Education Credits

17	Subtract line 16 from line 15			17	450
18	Add line 4 and line 8c. If you have no entry on these lines, skip lines 19 through 24, and enter the amount from line 17 on line 25			18	
19	Enter: $120,000 if married filing jointly; $60,000 if single, head of household, or qualifying widow(er)	19			
20	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	20			
21	Subtract line 20 from line 19. If zero or less, skip lines 22 and 23, and enter zero on line 24	21			
22	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	22			
23	If line 21 is: • Equal to or more than line 22, enter the amount from line 18 on line 24 and to line 25 • Less than line 22, divide line 21 by line 22. Enter the result as a decimal (rounded to at least three places)			23	.
24	Multiply line 18 by line 23 ▶			24	
25	Add line 17 and line 24. If zero, **stop;** you **cannot** take any nonrefundable education credit			25	450
26	Enter the amount from Form 1040, line 46, or Form 1040A, line 28			26	4,813
27	Enter the total, if any, of your credits from: • Form 1040, lines 47, 48, and the amount from Schedule R (Form 1040) entered on line 53 • Form 1040A, lines 29 and 30			27	
28	Subtract line 27 from line 26. If zero or less, **stop**; you **cannot** take any nonrefundable education credit			28	4,813
29	**Nonrefundable education credits.** Enter the **smaller** of line 25 or line 28 here and on Form 1040, line 49, or Form 1040A, line 31			29	450

*If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

Form 8863 (2009)

4

GENERAL OBSERVATIONS

1. The **formula** for computing the AOC for 2009 and 2010 is:
   - 100% of the first $2,000 of qualifying tuition and related expenses, **plus**
   - 25% of the next $2,000,
   - Limited to a maximum of $2,500 for each eligible student.[108]
2. The AOC is allowed for all **four years** of post-secondary education rather than just the freshman and sophomore years.[109] In addition, the AOC can be claimed for **four tax years,**[110] which is paradoxical considering that by statute it currently applies only for 2009 and 2010.[111]
3. The **phaseout for high-income taxpayers** is liberalized for 2009 and 2010.[112] Therefore, many high-income taxpayers who were previously denied education credits on Form 8863 will be eligible to claim these credits under the taxpayer-friendly rules that apply for 2009 and 2010. The phaseout ranges for 2009 are shown below.

Filing Status	2009 Modified AGI Phaseout Range
All except married filing jointly	$ 80,000–$ 90,000 (rather than $50,000[113] – $60,000)
Married filing jointly	160,000– 180,000 (rather than $100,000[114] – $120,000)

Note. Prior to the ARRA, the lower modified AGI phaseout ranges shown in parentheses in the above table were scheduled to apply for 2009. This is one of few provisions of the ARRA that is beneficial to high-income taxpayers.

4. Any tuition and fees **paid in 2008** for an academic period that begins in January through March of 2009 **do not qualify** for the 2009 AOC. Instead, these expenses must be shown on the **2008** Form 8863 and computed under the prior rules of law for the Hope credit. An inspection of box 7 of the 2008 Form 1098-T shows if this situation is a possibility.

Note. The maximum 2009 deduction on Form 8917, *Tuition and Fees Deduction*, is $4,000, and the maximum lifetime learning credit is $2,000. For students who qualify for all three provisions, the AOC will almost always yield the most tax savings.

108. IRC §25A(i)(1).
109. IRC §25A(i)(2).
110. Ibid.
111. IRC §25A(i).
112. IRC §25A(i)(4).
113. Rev. Proc. 2008-66, Section 3.05(2), 2008-45 IRB 1107 (Nov. 10, 2008).
114. Ibid.

RELIEF IN THE MIDWESTERN DISASTER AREA[115]

The Tax Extenders and AMT Relief Act of 2008 doubled the maximum Hope credit to $3,600 and the maximum lifetime learning credit to $4,000 for students attending institutions in the **Midwestern disaster area. These favorable law changes apply to tax years 2008 and 2009.**

For both the modified education credits and the tuition and fees deduction, qualified education expenses include:

- Tuition and fees;
- Books, supplies, and equipment;
- Computer technology, Internet access, and related services; and
- Room and board.

Room and board expenses are allowed only for students who are enrolled at least half-time. In addition, the maximum amount of room and board expense that can be included varies by college.[116] The taxpayer must contact the institution for the applicable limits.[117]

Example 16. Jed Lilly attended John Wood Community College (JWCC) during both semesters of 2008. He was a full-time student. Since JWCC is in Adams County, Illinois, Jed qualifies as a Midwestern disaster area student. He lived in a rented apartment near the college during the nine months school was in session.

His parents, Fred and Rose Lilly, paid all of Jed's educational expenses to attend JWCC. They claimed Jed's exemption on their 2008 joint tax return. Their 2008 modified AGI was $90,000.

Jed received the following 2008 Form 1098-T from JWCC.

☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone number John Wood Community College 1301 South 48th Street Quincy, IL 62305 Contact Tel. No. (217) 641-4202		1 Payments received for qualified tuition and related expenses $ 2 Amounts billed for qualified tuition and related expenses $ 2900.00	OMB No. 1545-1574 2008 Form 1098-T	Tuition Statement
FILER'S federal identification no. 42-1234567	STUDENT'S social security number 001-02-0003	3 If this box is checked, your educational institution has changed its reporting method for 2008 ☐		Copy B For Student
STUDENT'S name Jed Lilly		4 Adjustments made for a prior year $	5 Scholarships or grants $	This is important tax information and is being furnished to the Internal Revenue Service.
Street address (including apt. no.) 102 Blue Springs Drive City, state, and ZIP code Dallas City, IL 62330		6 Adjustments to scholarships or grants for a prior year $	7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January - March 2009 ▶ ☒	
Service Provider/Acct. No. (see instr.)	8 Checked if at least half-time student ☒	9 Checked if a graduate student ☐	10 Ins. contract reimb./refund $	

Form 1098-T (keep for your records) Department of the Treasury - Internal Revenue Service

Fred and Rose paid the following educational expenses for Jed in 2008:

Tuition and fees	$2,700	
Books	500	
Room and board	4,000	(meets the reasonable-cost test)
Total paid in 2008	**$7,200**	

Fred and Rose were entitled to a $3,600 Hope credit on their 2008 Form 8863. This is double the normal maximum 2008 Hope credit of $1,800.

115. The Tax Extenders and AMT Relief Act of 2008 provided that certain sections of the IRC be applied to any Midwestern disaster area in addition to the area specified in the Code.

116. See IRC §529(e)(3)(B)(ii) for the formula.

117. IRS Pub. 4492-B, *Information for Affected Taxpayers in the Midwestern Disaster Areas* (Rev. Jan. 2009).

For Example 16

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions to find out if you are eligible to take the credits.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074
2008
Attachment Sequence No. 50

Name(s) shown on return: **Fred and Rose Lilly**

Your social security number

Caution:
- *You **cannot** take the Hope credit and the lifetime learning credit for the **same student** in the same year.*
- *You **cannot** take both an education credit and the tuition and fees deduction (see Form 8917) for the **same student** for the same year.*

Part I Hope Credit. Caution: *You **cannot** take the Hope credit for more than **2** tax years for the **same student.***

1	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). **Do not** enter more than \$2,400* for each student.	(d) Enter the **smaller** of the amount in column (c) or \$1,200**	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)
	Jed Lilly	001 02 0003	4,800	2,400	7,200	3,600

*For each student who attended an eligible educational institution in a Midwestern disaster area, **do not** enter more than \$4,800.
For each student who attended an eligible educational institution in a Midwestern disaster area, enter the **smaller of the amount in column (c) or \$2,400.

2	**Tentative Hope credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶	2	3,600

Part II Lifetime Learning Credit

3	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)

4	Add the amounts on line 3, column (c), and enter the total	4	
5a	Enter the **smaller** of line 4 or \$10,000	5a	
b	For students who attended an eligible educational institution in a Midwestern disaster area, enter the smaller of \$10,000 or their qualified expenses included on line 4 (see special rules on page 3)	5b	
c	Subtract line 5b from line 5a	5c	
6a	Multiply line 5b by 40% (.40)	6a	
b	Multiply line 5c by 20% (.20)	6b	
c	**Tentative lifetime learning credit.** Add lines 6a and 6b and go to Part III	6c	

Part III Allowable Education Credits

7	Tentative education credits. Add lines 2 and 6c			7	3,600
8	Enter: \$116,000 if married filing jointly; \$58,000 if single, head of household, or qualifying widow(er)	8	116,000		
9	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	9	90,000		
10	Subtract line 9 from line 8. If zero or less, **stop;** you cannot take any education credits	10	26,000		
11	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	11	20,000		
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	× .
13	Multiply line 7 by line 12 ▶			13	3,600
14	Enter the amount from Form 1040, line 46, or Form 1040A, line 28			14	9,594
15	Enter the total, if any, of your credits from Form 1040, lines 47 through 49, or Form 1040A, lines 29 and 30			15	0
16	Subtract line 15 from line 14. If zero or less, **stop;** you cannot take any education credits ▶			16	9,594
17	**Education credits.** Enter the smaller of line 13 or line 16 here and on Form 1040, line 50, or Form 1040A, line 31 ▶			17	3,600

* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2008)

Observations for Example 16.

1. The 2008 maximum Hope credit for a Midwestern disaster area student is $3,600 provided at least $4,800 of net qualified education expenses were paid in 2008. The same applies for 2009.[118]

2. The box 2 amount of $2,900 shown on Jed's 2008 Form 1098-T cannot be relied on to compute the Hope credit for Jed's parents because of the expanded definition of qualified expenses.

3. Amended returns for 2008 can be filed if the maximum education credit for a Midwestern disaster area student was not claimed on the original 2008 tax return.

4. Students who attend colleges located in the Midwestern disaster area in 2009 might qualify for both the Midwestern Hope credit and the AOC. Since the Midwestern Hope credit will yield a higher credit, taxpayers may elect to waive the AOC and use the Midwestern Hope credit instead.[119]

The following table[120] shows the counties in the Midwestern disaster area:

Table 3-2. **Table 1 from Publication 4492-B**

Students attending an eligible educational institution in the counties listed below may qualify for the special Midwestern disaster area rules for the Hope or lifetime learning credit or the tuition and fees deduction.

Applicable Disaster Date*	State	Affected Counties—Midwestern Disaster Areas
05/02/2008	Arkansas	Arkansas, Benton, Cleburne, Conway, Crittenden, Grant, Lonoke, Mississippi, Phillips, Pulaski, Saline, and Van Buren.
06/01/2008	Illinois	Adams, Calhoun, Clark, Coles, Crawford, Cumberland, Douglas, Edgar, Hancock, Henderson, Jasper, Jersey, Lake, Lawrence, Mercer, Rock Island, Whiteside, and Winnebago.
06/06/2008	Indiana	Adams, Bartholomew, Brown, Clay, Daviess, Dearborn, Decatur, Gibson, Grant, Greene, Hamilton, Hancock, Hendricks, Henry, Huntington, Jackson, Jefferson, Jennings, Johnson, Knox, Lawrence, Madison, Marion, Monroe, Morgan, Owen, Parke, Pike, Posey, Putnam, Randolph, Ripley, Rush, Shelby, Sullivan, Tippecanoe, Vermillion, Vigo, Washington, and Wayne.
05/25/2008	Iowa	Adair, Adams, Allamakee, Appanoose, Audubon, Benton, Black Hawk, Boone, Bremer, Buchanan, Butler, Cass, Cedar, Cerro Gordo, Chickasaw, Clarke, Clayton, Clinton, Crawford, Dallas, Davis, Decatur, Delaware, Des Moines, Dubuque, Fayette, Floyd, Franklin, Fremont, Greene, Grundy, Guthrie, Hamilton, Hancock, Hardin, Harrison, Henry, Howard, Humboldt, Iowa, Jackson, Jasper, Johnson, Jones, Keokuk, Kossuth, Lee, Linn, Louisa, Lucas, Madison, Mahaska, Marion, Marshall, Mills, Mitchell, Monona, Monroe, Montgomery, Muscatine, Page, Polk, Pottawattamie, Poweshiek, Ringgold, Scott, Story, Tama, Union, Van Buren, Wapello, Warren, Washington, Webster, Winnebago, Winneshiek, Worth, and Wright.
05/10/2008	Missouri	Barry, Jasper, and Newton.
06/01/2008	Missouri	Adair, Andrew, Callaway, Cass, Chariton, Clark, Gentry, Greene, Harrison, Holt, Johnson, Lewis, Lincoln, Linn, Livingston, Macon, Marion, Monroe, Nodaway, Pike, Putnam, Ralls, St. Charles, Stone, Taney, Vernon, and Webster.
05/22/2008	Nebraska	Buffalo, Butler, Colfax, Custer, Dawson, Douglas, Gage, Hamilton, Holt, Jefferson, Kearney, Lancaster, Platte, Richardson, Sarpy, and Saunders.
06/05/2008	Wisconsin	Adams, Calumet, Crawford, Columbia, Dane, Dodge, Fond du Lac, Grant, Green, Green Lake, Iowa, Jefferson, Juneau, Kenosha, La Crosse, Manitowoc, Marquette, Milwaukee, Monroe, Ozaukee, Racine, Richland, Rock, Sauk, Sheboygan, Vernon, Walworth, Washington, Waukesha, and Winnebago.

* In some cases, the date will be later due to the continuation of the severe storms, tornadoes, or flooding that began on the above date. For more details, go to *www.fema.gov*

118. Rev. Proc. 2008-66 Section 3.05(2) 2008-45 IRB 1107 (Nov. 10, 2008).

119. IRC §25A(i)(7).

120. IRS Pub. 970, *Tax Benefits for Education*, p. 27 (2008).

PROBLEM 7: 2007 1040-A "STIMULUS PAYMENT" TAX RETURNS

Practitioners and taxpayers should be aware that some taxpayers that filed the 2007 "Stimulus Payment" Form 1040-A have been receiving notices from the IRS indicating that they owe taxes, interest, and penalty for 2007. The situation that has arisen stems from married taxpayers who received social security during 2007 and filed separate 1040-A "Stimulus Payment" tax returns. As instructed by the IRS with press releases and through various media outlets, in order to receive their $300 stimulus check, these individuals were to file a Form 1040-A showing at least $3,000 of social security income on the form while writing "Stimulus Payment" at the top of the tax return. The IRS has processed these returns as "married filing separately." Since married filing separate taxpayers don't get the benefit of the $25,000 threshold for the determination of the taxability of social security as single taxpayers do, some taxpayers with other taxable income are being assessed tax for 2007. The IRS will match up any other reported income for the taxpayer and assess tax, interest, and penalty if any is due and mail the taxpayer a notice.

Upon investigating one such case, a call to the IRS practitioner hotline support representative said that the IRS has been "flooded" with calls from taxpayers with this same situation. When asked what advice is given to taxpayers/ practitioners when they call in, they responded, "We're telling them to pay it."

If the taxpayer lived with his spouse at any time during 2007, and the spouse consents, they can file an amended joint return and include all taxable income showing that when filing jointly, there is no tax liability. If the taxpayer did not live with his spouse at any time during 2007, then a letter stating such should be sent to the IRS explaining the facts and circumstances so that the taxpayer will get the more favorable calculation for the taxability of the social security proceeds.