Chapter 5: Individual Taxpayer Problems

Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

PROBLEM 1: EIC DUE-DILIGENCE UPDATE

Note. For EIC due diligence examples and a copy of Form 8867, *Paid Preparer Earned Income Credit Checklist,* see Chapter 8, IRS Update, in the 2008 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

BACKGROUND

The earned income credit (EIC) was initiated in 1975, in part to offset the burden of social security taxes, and to provide an incentive to work. It has evolved over the years into an important federal anti-poverty program.[1] According to IRS estimates, over 25 million taxpayers claimed $51.6 billion of EIC on 2008 tax returns.[2]

For the past several years, the IRS has adjusted its processes to stop EIC fraud without unduly delaying the refunds of honest taxpayers.[3] In 2007, the IRS implemented changes to protect taxpayers' rights in response to recommendations made by the National Taxpayer Advocate. In 2008, the Treasury Department recommended that some of the changes implemented in 2007 be rescinded in light of the "exponential growth" in EIC fraud from 2006 to 2007.

TIGTA[4]

In a report on how the IRS is managing the EIC program, the Treasury Inspector General for Tax Administration (TIGTA) detailed some of the problems with administrating the program and made specific recommendations for improvement. This report includes the response from the IRS on its plans regarding the program.

According to IRS estimates, 23% to 28% of EIC payments were paid in error in 2004. The IRS estimates that in 2006, **erroneous EIC payments were between $10 and $12 billion.** The TIGTA report cites a number of reasons for this:

- The requirements for eligibility are complex and frequently change.
- The IRS is unable to independently validate whether taxpayers meet the requirements to claim the credit without auditing the returns.
- Only 20% of taxpayers claiming the EIC consistently claim the credit from year to year. This frustrates IRS efforts to identify and educate potential claimants.

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1. Treasury Inspector General for Tax Administration, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments*, Reference Number: 2009-40-024 (2008).
2. Parisi, M., "Individual Income Tax Returns, Preliminary Data: 2008," (Winter 2010). *Statistics of Income Bulletin, 29,* p. 7.
3. National Taxpayer Advocate, *Report to Congress: Fiscal Year 2010 Objectives* (2009).
4. Treasury Inspector General for Tax Administration, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments*, Reference Number: 2009-40-024 (2008).

Observation. The IRS also estimates that historically, **one in four** taxpayers who **are eligible for EIC fail to claim it.**[5] To address this problem, the IRS is participating in a number of outreach efforts to increase awareness of the credit.

In its response, the IRS noted that it cannot audit its way to EIC compliance. The IRS identified several alternative ways to address the issue:

1. **Soft Notices.** The IRS sends notices to taxpayers when a qualifying child for EIC purposes is claimed by more than one taxpayer. The notices request that the taxpayers voluntarily correct their returns. In one study, 85% of recipients of such letters did not repeat the error in the subsequent year. The IRS is studying the use of soft notices for other areas of EIC noncompliance.

2. **Preparer Involvement.** The IRS notes that 70% of EIC returns are prepared by paid preparers. By targeting preparers, the IRS hopes to exponentially affect the accuracy of EIC returns.

3. **Dependent Database.** The IRS currently compares returns containing EIC claims to its dependent database when the returns are filed. Based on the comparison, returns are flagged for possible audit.

   The database is comprised of information provided by the Social Security Administration and the Department of Health and Human Services (HHS). The HHS data is called the Federal Case Registry. The registry's information is provided by the states and includes such information as divorce decrees and child custody orders.

   As part of its efforts to find new ways to combat EIC errors, the IRS will study expanding the role of the Federal Case Registry. It will also investigate the appropriateness of using the IRS's existing **math error authority** to deny an EIC claim during the upfront processing of the return based on information inconsistent with the registry.

TAX RETURN PREPARER INVOLVEMENT[6]

The IRS has a multifaceted strategy to improve EIC compliance by targeting tax return preparers who need education about the law or encouragement to do a better job of interpreting the rules. The efforts range from letters to personal visits to administrative sanctions. The IRS is taking the following steps:

1. Reaching out to new preparers
2. Educating experienced preparers by mail
3. Visiting preparers filing questionable returns
4. Verifying due diligence onsite
5. Fast-tracking referrals to the U.S. Department of Justice to enjoin preparers making flagrant and fraudulent EIC claims

5. [www.irs.gov/newsroom/article/0,,id=218828,00.html] Accessed on Aug. 17, 2010.
6. [www.irs.gov/individuals/article/0,,id=179024,00.html] Updated June 25, 2010. Accessed on Aug. 17, 2010.

Reaching Out to New Preparers

The IRS identifies first-time tax return preparers whose returns contained EIC-related errors. Using a scoring system to determine the degree of future risk, it sends correspondence to the higher-risk preparers. The letters may be simply informational or may contain stronger compliance warnings. In general, the letters:

- Outline due-diligence responsibilities,
- Highlight common errors made by EIC return preparers,
- Identify tools and resources to aid compliance, and
- Remind preparers that tax software is a tool, not a substitute for knowing and correctly applying the tax law.

Educating Experienced Preparers by Mail

A scoring system, similar to the one used for first-time preparers, is used to identify experienced preparers whose 2009 returns contained errors and questionable claims. The higher-risk practitioners receive correspondence focused on EIC education.

Visiting Preparers Filing Questionable Returns

IRS revenue agents and criminal investigation special agents personally visit preparers who file returns with highly questionable EIC claims. During these visits, agents:

- Discuss the identified errors,
- Offer advice and solutions,
- Answer questions to help preparers comply with the law, and
- Explain the potential consequences of noncompliance.

Verifying Due Diligence On-Site

The IRS conducts on-site audits of preparers who file a **high percentage of questionable EIC claims and/or returns with a high risk of EIC erro**r. During these audits, agents review the preparer's records for due-diligence compliance, including the knowledge standard. Penalties of **$100 per occurrence**[7] are assessed if the preparer is not compliant with the due-diligence requirements. **More than 90% of the due-diligence preparer penalties assessed during these audits result from failure to comply with the knowledge standard.**

Fast-Tracking Referrals to the U.S. Department of Justice

Preparers making flagrant and fraudulent EIC claims are referred to the Justice Department. These preparers could be:

- Disciplined by the IRS Office of Professional Responsibility,
- Temporarily barred from preparing any type of federal tax return,
- Permanently barred from preparing any type of federal tax return,
- Prosecuted for criminal behavior,
- Fined $1,000 if the EIC claim is based on an unreasonable position, or
- Fined $5,000 if the EIC claim is due to reckless or intentional disregard of rules/regulations.

7. IRC §6695(g).

Additionally, the preparer's firm can be suspended or expelled from the IRS e-file program.

> **Observation.** Since most professional tax return preparers are required to e-file all eligible returns after December 31, 2010,[8] being expelled from the e-file program will effectively put the firm out of business. This underscores the importance of proper training and oversight of employees.

EIC DUE-DILIGENCE REQUIREMENTS[9]

There are four due-diligence requirements:

1. **Eligibility Checklist.** The IRS has designed Form 8867, *Paid Preparer's Earned Income Credit Checklist,* to satisfy this requirement. However, preparers may use their own checklists if the information is equivalent.
2. **Appropriate Worksheets.** Preparers are required to keep the EIC worksheet from the Form 1040 instructions or an equivalent showing how the credit was computed. Tax preparation software that contains acceptable equivalent worksheets may be used to retain this information in lieu of paper copies of the worksheets.
3. **Knowledge.** This is the **key** requirement. The regulations specifically require that the preparer:
   - Not know **or have reason to know** that any information used in determining the taxpayer's **eligibility** for the credit is incorrect, incomplete, or inconsistent;
   - Not know **or have reason to know** that any information used in determining the **amount** of the credit is incorrect, incomplete, or inconsistent;
   - Not ignore the implications of information furnished or known;
   - Make reasonable inquiries if a reasonable and well-informed tax return preparer, knowledgeable in the law, would conclude the information furnished appears to be incorrect, inconsistent, or incomplete; and
   - Document any inquiries made and any responses provided.
4. **Record Retention.** The following must be retained for three years after June 30 following the date the return or claim was presented for signature:
   - The checklist
   - The worksheets
   - A record of how and when the information used to complete the checklist and worksheets was obtained, including the identity of any person furnishing the information

> **Caution.** Although it is uncommon, a return filed on an extension may contain EIC. If the return is filed after June 30, these records must be retained one year longer than returns filed during the filing season. Practitioners who regularly purge their client files after three years are cautioned to extract these records before others from the same tax year are destroyed.

8. IRC §6011(e)(3).
9. [www.irs.gov/individuals/article/0,,id=150531,00.html] Updated Dec. 18, 2009. Accessed on Aug. 17, 2010. See also Treas. Reg. §1.6695-2.

On its website, the IRS summarizes the knowledge requirement with these directives to preparers:

- Evaluate the information received from clients.
- Apply consistent and reasonable standards to the information.
- Ask additional questions if the information appears incorrect, inconsistent, or incomplete.

Another indication of what the IRS expects from preparers is found in IRS Pub. 4716, *Be Prepared to Get the Earned Income Tax Credit You Earned.* The IRS advises taxpayers to bring certain documents to their tax preparers to prove EIC eligibility. These documents include:

- A valid driver's license or photo identification for the taxpayer (and spouse, if applicable),
- Social security cards for all persons listed on the return, and
- Proof of an account at the financial institution used for a direct debit or deposit.

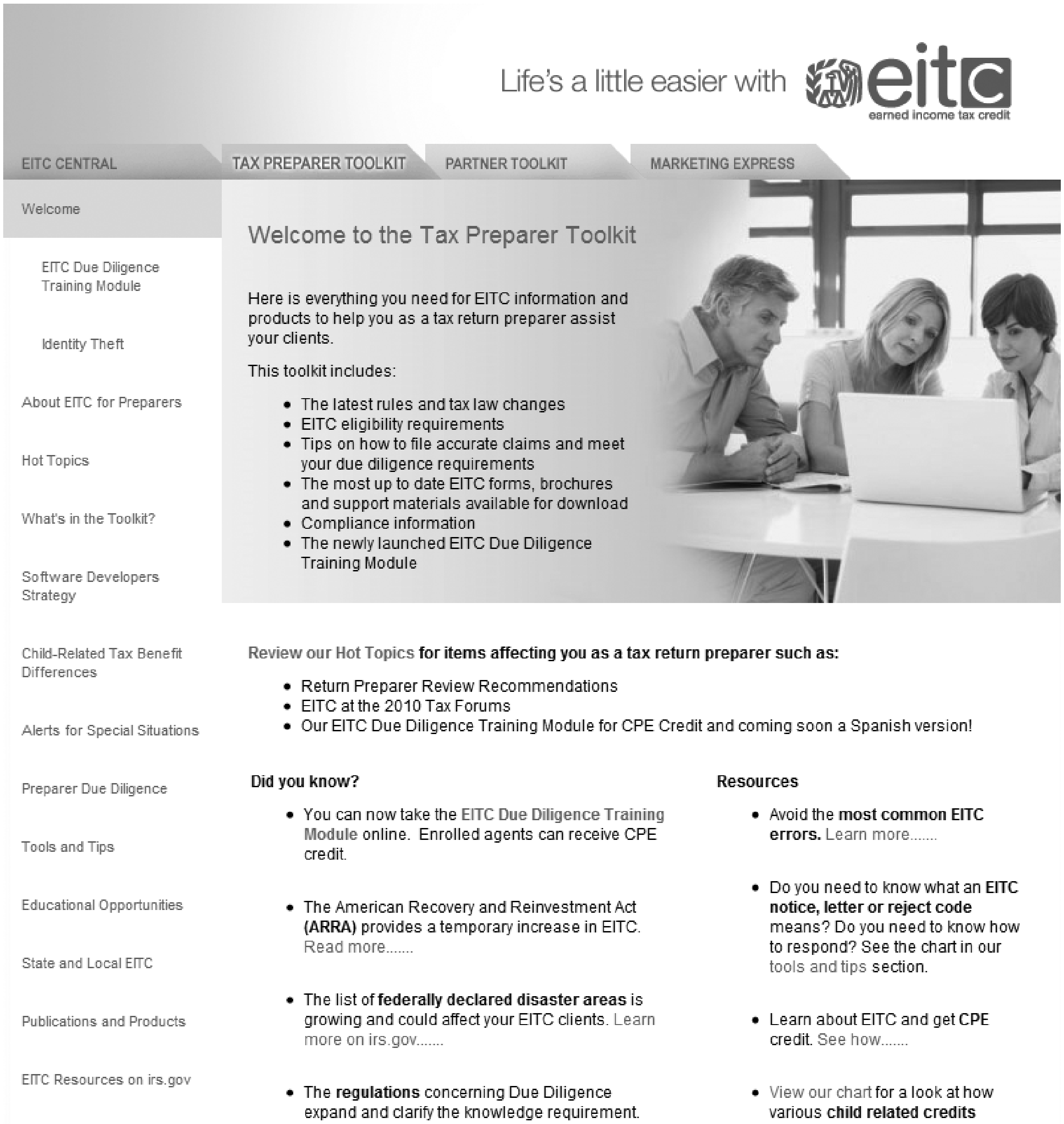
This publication also includes the following bit of wisdom:

> *Your Return Preparer, whether paid or volunteer, is required to ask you multiple questions to determine your correct income, expenses, deductions, and credits. Your Return Preparer has your best interests in mind and wants to help you avoid penalties, interest, or additional taxes that could result from later IRS contacts.*

EIC COMPLIANCE RESOURCES

The IRS offers a number of tools and publications to educate preparers and assist them in meeting the due-diligence requirements. There is a special website, the Tax Preparer Toolkit at **www.eitc.irs.gov/rptoolkit/main**, that includes almost everything a preparer would need to understand EIC and comply with the complex EIC rules. This website also has an EIC training module specifically designed for tax preparers. The module contains interactive scenarios with examples of applying the due-diligence requirements. Enrolled agents may obtain CPE credits for completing the related test.

The following image shows the main page for tax preparers.



Other resources (also available in Spanish) include:

- IRS Pub. 596, *Earned Income Credit;*
- Form 8862, *Information to Claim Earned Income Credit After Disallowance;* and
- EITC Assistant, a web-based tool to help determine EIC eligibility and calculate the credit.

The following IRS forms designed for **IRS examiners** to present to taxpayers can also be used by tax return preparers to explain to taxpayers what type of documentation would be necessary in the event of an audit:

- Form 886-H-DEP, *Supporting Documents for Dependency Exemptions*
- Form 886-H-EIC, *Documents You Need to Prove You Can Claim an Earned Income Credit on the Basis of a Qualifying Child*
- Form 886-H-HOH, *Supporting Documents to Prove Head of Household Filing Status*

PROBLEM 2: ROTH CONVERSIONS

BACKGROUND

The elimination of the $100,000 modified adjusted gross income (MAGI) limitation in 2010 for converting traditional IRAs to Roth IRAs has received extensive media coverage. As a result, many taxpayers believe that the only smart decision is to convert and that 2010 is the only year that they may convert. However, converting may not be the best choice for many taxpayers.

> **Note.** For more information about Roth conversions, see the 2009 *University of Illinois Federal Tax Workbook* (pp. 114–115 and 319–323) and the 2008 *University of Illinois Federal Tax Workbook* (pp. 451–452). This can be found on the accompanying CD.

The following is a synopsis of the current rules for Roth IRAs:

1. All taxpayers, regardless of income level, may elect to convert a traditional IRA, 401(k), 403(a), 403(b), or 457 retirement plan to a Roth IRA.[10] The AGI limitation is removed for **2010 and future years** under current tax law.[11]
2. For conversions made in 2010 only, taxpayers report taxable conversion income ratably in 2011 and 2012 **unless they elect** to include the entire taxable amount in 2010.[12] **The deadline to make or change this election is October 17, 2011.[13]**
3. The **election** to include the conversion in 2010 income applies to **all** Roth conversions made by that taxpayer. However, married taxpayers may make different elections **without** filing separate returns.[14]
4. Any amounts distributed from a converted Roth IRA before the entire amount has been included in income must be added to the otherwise includable amount in the year of the distribution. However, this inclusion amount is limited so that the taxpayer will not include more than the total distribution in income.[15]
5. Unless one of the exceptions for IRAs applies, distributions from a converted Roth IRA are subject to a 10% early withdrawal penalty if made within **five taxable years** from the date of the conversion.[16]
6. **Contributions to Roth IRAs are still subject to AGI limitations.[17]** However, conversions are **not** included in AGI for purposes of calculating the maximum Roth contribution.[18] See the Reference Material section at the end of this workbook for the 2010 phaseout ranges.

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10. IRC §408A(d)(3)(A).
11. Former IRC §408A(c)(3)(B) stricken by P.L. 109-222, *Tax Increase Prevention and Reconciliation Act of 2005,* for tax years beginning after December 31, 2009.
12. IRC §408A(d)(3)(A)(iii).
13. IRC §§408A(d)(3)(A) and 408A(d)(7).
14. Instructions for Form 8606, *Nondeductible IRAs.*
15. IRC §408A(d)(3)(E)(i).
16. Treas. Reg. §1.408A-6, Q&A-5(b).
17. IRC §408A(c)(3)(A).
18. IRC §408A(c)(3)(B)(i).

Example 1. Mary Beth, age 58, and Howard, age 59, have combined wages of $135,000 in 2010. They convert $120,000 of traditional IRAs to Roth IRAs in 2010. They have no basis in their traditional IRAs. They want to know if they can each contribute $6,000 to their Roth IRAs for 2010.

Tax Result. Mary Beth's and Howard's 2010 AGI is $255,000 ($135,000 + 120,000). However, their MAGI is only $135,000 for purposes of calculating the allowable Roth contribution amount. Since $135,000 is below $165,000, the beginning of the phaseout range, they are each allowed to contribute the maximum amount of $6,000 to their Roth IRAs.

UNPLANNED CONSEQUENCES OF ROTH CONVERSIONS

In addition to the income taxes due on the taxable conversion amount, there may be unplanned financial consequences from a Roth IRA conversion.

Increased Medicare Part B Premiums[19]

The Medicare Part B premiums paid by consumers are based on their MAGI as reported on the tax returns **filed** the previous year. For example, the 2010 monthly premium is based on the 2008 tax return filed in 2009. Most people with Part B coverage only pay about 25% of the actual premium and the government pays the balance. However, for higher-income beneficiaries, the corresponding percentage is 35% to 80%, depending on the level of their income.

MAGI equals AGI plus tax-exempt interest. The following table shows the 2010 premiums by MAGI level:

MAGI		
Individuals	**Married Couples**	**Medicare Part B Premium**
$ 0– 85,000	$ 0–170,000	$110.50 [a]
85,001–107,000	170,001–214,000	154.70
107,001–160,000	214,001–320,000	221.00
160,001–214,000	320,001–428,000	287.30
>214,000	>428,000	353.60

[a] Capped at $96.40 for most participants

19. Social Security Administration, *Medicare Part B Premiums: Rules for Beneficiaries with Higher Incomes,* Publication No. 05-10161 ICN 46880 (Jan. 2010).

Example 2. Adan and Beatriz reported a 2008 AGI of $120,000. They each participate in Medicare Part B and their 2010 monthly premiums are $96.40 each. Previously, their AGI was too high to convert their existing traditional IRAs to Roth IRAs.

In 2010, they convert $500,000 from their traditional IRAs to Roth IRAs. They have no basis in the traditional IRAs and no tax-exempt interest income. Before consideration of the conversions, their 2010 AGI is $130,000.

Tax Result A. Adan and Beatriz report the entire $500,000 taxable conversion on their **2010** return. Their MAGI is $630,000 ($130,000 + 500,000). Assuming the 2012 Medicare Part B premium rates remain at the 2010 levels shown in the prior chart, they will **each** pay $353.60 per month.

This is $257.20 more per month than the $96.40 they would have paid without the 2010 Roth conversion. The total additional Part B premium cost for the entire year is **$6,172.80** ($257.20 × 2 people × 12 months).

Tax Result B. Adan and Beatriz report **half** of their $500,000 2010 taxable Roth conversion on their **2011 and 2012** returns. Their 2011 and 2012 income is the same as 2010. If they report $250,000 of the conversion in each of these years, their MAGI will be $380,000.

Assuming that the Part B premium rates stay at the same level shown in the prior table, in 2013 and 2014 Adan and Beatrice will **each** pay Part B monthly premiums of $287.30. This is $190.90 more per month than the $96.40 they would have paid with no 2010 Roth conversion. The total additional cost for both years is **$9,163.20** ($190.90 × 2 people × 24 months).

Higher Taxation of Social Security Benefits

Lower-income taxpayers, who qualified for a Roth conversion prior to 2010, may be enticed into a 2010 conversion because of the option to spread the taxation over two years. This could be detrimental if their social security benefits are not usually included in income.

Example 3. Beatrice is 63 years old and single. In 2010, her entire income consists of $16,000 in social security benefits and $10,000 in interest income. Worried about future tax rates and required minimum distributions, she converts $800,000 in traditional IRA funds into Roth IRAs.

Tax Result A. Beatrice reports the entire taxable Roth conversion in 2010, resulting in an AGI of $810,000 before taxable social security benefits. Therefore, 85% of her $16,000 in social security benefits is taxable. As a result, her additional 2010 federal tax liability on the social security benefits is **$4,760** at the 35% tax rate.

Tax Result B. Beatrice reports half of the distribution in each of 2011 and 2012. Her AGI in each year will be $410,000 before taxable social security benefits. She will pay $4,760 **each year** in additional federal income taxes on the social security benefits.

Alternative Minimum Tax (AMT)

Even taxpayers who have no special adjustments for AMT can find that their high incomes create AMT. In addition, not all tax credits applicable to regular tax are subtracted from AMT.

Example 4. Michael and Tracy earn $200,000 per year. They have two daughters. They do not normally pay AMT. In 2010, they converted $100,000 from their traditional IRAs to a Roth IRA. If they report the entire conversion in 2010, they will pay $10,199 in AMT based on tax law in effect as of August 2010. Assuming the AMT exemption remains at 2010 levels in 2011 and 2012 and their income stays the same, if they report $50,000 in each of those years, they will pay $9,199 each year in AMT.

Observation. Congress will probably revise the 2010, 2011, and 2012 AMT exemptions and tax rates to levels comparable to those in effect for 2009. If this happens, the AMT in **Example 4** will be closer to $2,000 each year.

Estimated Tax Penalties[20]

Taxpayers are required to make estimated tax payments if they expect to owe more than $1,000 after subtracting withholding and other payments. Generally, taxpayers are not penalized for failure to make estimates if their payments and refundable credits equal either:

1. At least 90% of the current year's total tax, **or**
2. At least 100% of the total tax shown on the previous year's return.

One exception to the safe harbor applies to taxpayers whose AGI exceeded $150,000 for the previous tax year ($75,000 for MFS taxpayers). These taxpayers must substitute 110% for 100% in the second safe harbor.

The taxable income reported in 2010, 2011, or 2012 from conversions to Roth IRAs is included in AGI to determine whether the 110% level applies. Additional tax due from the conversions will also be included in the total tax used to determine if the safe harbor exceptions are met.

Note. The underpayment penalty is equal to the interest that would accrue on the underpayment for the period of time the estimate is underpaid. The rate varies according to the federal short-term rate.

Reduced $25,000 Special Allowance for Rental Real Estate Activities[21]

Generally, deductions for losses from passive activities are limited to income from passive activities. However, taxpayers who actively participate in rental real estate activities may deduct up to $25,000 of related passive losses. This $25,000 cap is reduced for taxpayers with MAGI over $100,000 and completely phased out for taxpayers whose MAGI exceeds $150,000. Different limits apply to MFS taxpayers. The total deductible loss is calculated in Part II of Form 8582, *Passive Activity Loss Limitations*.

Taxable income from Roth IRA conversions is included in MAGI for these purposes. Taxpayers with large conversions may be surprised by additional taxes due from the loss of the $25,000 special allowance.

20. IRC §6654(d).

21. IRC §469(i).

Other Tax Benefits Based on AGI

> **Note.** Income from a Roth conversion is not included in AGI for purposes of calculating the maximum Roth IRA contribution allowable.

There are a large number of tax benefits that are limited, phased out, or denied to taxpayers with AGIs over certain levels. When making the decisions to convert retirement funds to Roth IRAs and which tax years to report the income, the tax effects on the following should also be considered:

- **Exclusions** such as interest on savings bonds redeemed for qualified higher-education expenses[22] and employer-provided adoption assistance[23]
- **Deductibility** of traditional IRA contributions,[24] student loan interest,[25] and qualified higher-education expenses (if extended)[26]
- **Allowable contributions** to Coverdell education accounts[27]
- **Itemized deductions**, including the overall limitation,[28] the 7.5% floor for medical deductions,[29] the 2% floor for miscellaneous itemized deductions,[30] the 10% floor for casualty losses,[31] and the amount of the mortgage insurance premium deduction[32]
- **Personal exemptions[33]**
- **Tax credits**, such as the earned income credit,[34] the child tax credit,[35] the dependent care credit,[36] the elderly and disabled credit,[37] the adoption credit,[38] the lifetime learning credit,[39] the ' for 2010,[40] the Hope credit for 2011 and 2012,[41] the making work pay credit[42] (if extended), the retirement savers credit,[43] and first-time homebuyer credit[44]

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22. IRC §135.
23. IRC §137.
24. IRC §219.
25. IRC §221.
26. IRC §222.
27. IRC §530(b).
28. IRC §68.
29. IRC §213.
30. IRC §67.
31. IRC §165(h).
32. IRC §163(h)(3)(E).
33. IRC §151.
34. IRC §32.
35. IRC §24.
36. IRC §21.
37. IRC §22.
38. IRC §23.
39. IRC §25A.
40. Ibid.
41. Ibid.
42. IRC §36A.
43. IRC §25B.
44. IRC §36.

Other Benefits Based on Tax Returns

Many organizations use the information reported on income tax returns to determine eligibility for the group's programs. Additional income from Roth IRA conversions may affect some of these benefits. Some examples include the following:

- Student loans and financial aid
- Income-based repayment options for federal student loans
- Local real estate tax discounts and freezes, usually applicable for senior citizens

CONVERSIONS OF PLANS WITH BASIS

Both traditional IRAs and employer-provided retirement plans may have been funded with after-tax dollars. When these funds are converted to Roth IRAs, the basis must be considered when calculating the taxable portion of the conversion.

Traditional IRAs

The nontaxable portion of the conversion is based on the pro-rata share of basis to the total value of the IRAs.[45] If all traditional IRAs are converted, then the entire basis is used to reduce the taxable portion. However, the taxpayer does not get the benefit of the entire basis if only a portion of the traditional IRAs are converted. In addition, the growth of the traditional IRAs during the year of conversion diminishes the effect of the basis on the conversion.

Example 5. Demarco has $400,000 in his traditional IRAs as of December 31, 2009. His cumulative nondeductible contributions are $40,000. In 2010, he converts $200,000 to Roth IRAs. He elects to report the entire conversion on his 2010 return. As of December 31, 2010, the value of his traditional IRAs is $210,000.

Tax Result. Demarco expects 10% of the rollover to be tax free because his $40,000 basis is 10% of his $400,000 traditional IRA value at the end of the year prior to the conversion. However, as shown on the following Form 8606, *Nondeductible IRAs*, only 9.756% (line 10) of his rollover is tax free. The higher the value of his traditional IRAs on December 31, 2010, the lower his tax-free percentage.

The tax-free amount of his conversion is $19,512 (line 17) and the taxable portion is $180,488 (line 18).

45. Treas. Reg. §1.408A-4, Q&A-7.

For Example 5

Form **8606** Department of the Treasury Internal Revenue Service (99)

Nondeductible IRAs

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

OMB No. 1545-0074 2010 Attachment Sequence No. 48

Name. If married, file a separate form for each spouse required to file Form 8606. See page 5 of the instructions.
Demarco

Your social security number
311-11-0011

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

Part I **Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs**

Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2010.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2010 **and** you made nondeductible contributions to a traditional IRA in 2010 or an earlier year. For this purpose, a distribution does not include a rollover, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2010 (excluding any portion you recharacterized) **and** you made nondeductible contributions to a traditional IRA in 2010 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2010, including those made for 2010 from January 1, 2011, through April 15, 2011 (see page 5 of the instructions)			1	
2	Enter your total basis in traditional IRAs (see page 5 of the instructions)			2	40,000
3	Add lines 1 and 2			3	40,000
	In 2010, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? **No** ▶ Enter the amount from line 3 on line 14. Do not complete the rest of Part I. **Yes** ▶ Go to line 4.				
4	Enter those contributions included on line 1 that were made from January 1, 2011, through April 15, 2011			4	
5	Subtract line 4 from line 3			5	40,000
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2010, plus any outstanding rollovers. (see page 6 of the instructions)	6	210,000		
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2010. **Do not** include rollovers, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see page 6 of the instructions)	7	0		
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2010. **Do not** include amounts converted that you later recharacterized (see page 6 of the instructions). Also enter this amount on line 16	8	200,000		
9	Add lines 6, 7, and 8 — 9: 410,000				
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× 0 . 09756		
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11	19,512		
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12	0		
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions			13	19,512
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2010 and earlier years**			14	20,488
15	**Taxable amount.** Subtract line 12 from line 7. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b			15	0

Note: *You may be subject to an additional 10% tax on the amount on line 15 if you were under age 59½ at the time of the distribution (see page 7 of the instructions).*

Part II **2010 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs**

Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2010 (excluding any portion you recharacterized).

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2010. **Do not** include amounts you later recharacterized back to traditional, SEP, or SIMPLE IRAs in 2010 or 2011 (see page 7 of the instructions)	16	200,000
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see page 7 of the instructions)	17	19,512

For Privacy Act and Paperwork Reduction Act Notice, see page 8 of the instructions. Cat. No. 63966F Form **8606** (2010)

For Example 5

Form 8606 (2010) Page 2

Part II **2010 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs** (Continued)

18	**Taxable amount.** Subtract line 17 from line 16.	18	180,488
19	**Amount subject to tax in 2010.** Check the box if you elect to report the entire taxable amount in 2010 rather than reporting 1/2 of it in 2011 and 1/2 in 2012 (see page x of the instructions) . . . . ☑ If you checked the box, enter the amount from line 18 on this line and include this amount on Form 1040, line 15b, Form 1040A, line 11b, or Form 1040NR, line 16b. If you did not check the box, skip line 19 and go to line 20a.	19	180,488
20a	**Amount subject to tax in 2011.** If you did not check the box on line 19, multiply the amount on line 18 by 50% (.50) and enter it here. Include this amount on the applicable line of your 2011 tax return	20a	
b	**Amount subject to tax in 2012.** Enter the amount from line 20a on line 20b. Include this amount on the applicable line of your 2012 tax return	20b	

Part III **Rollovers From Qualified Retirement Plans to Roth IRAs**

Draft as of 2010

> **Note.** Lines 20a and 20b show the amount that will be includable in income in 2011 and 2012 if the taxpayer does not elect to report the entire conversion in 2010.

Some analysts suggest that taxpayers whose income is above the limits for making Roth contributions may skirt the law by making nondeductible contributions to traditional IRAs and then immediately converting them to Roth IRAs. This work-around is only successful if the taxpayer has no balance in any other traditional IRAs. As shown in **Example 5**, for taxpayers with existing traditional IRAs, the total cumulative nondeductible contributions is compared to the total value of **all** traditional IRAs to determine the nontaxable portion of the conversion.

Employer-Sponsored Retirement Plans

Both the **taxable and nontaxable** portions of 401(k) and similar plans may be rolled over to a Roth IRA.[46] If the entire balance is **not** converted, the amount of the rollover is attributed **first to the taxable portion** of the distribution.[47]

Example 6. Maria retires in 2010. She has $300,000 in her employer's 401(k) program. During her 35 years with the company, she contributed $60,000 to the plan with **after-tax** money. She converts $150,000 of the balance to a Roth IRA in a direct trustee-to-trustee rollover. The entire $150,000 is includable in income.

Example 7. Use the facts from **Example 6,** except Maria rolls over $250,000 to a Roth IRA and receives the remaining $50,000 for a luxury vacation trip around the world. Only $240,000 of the conversion is taxable ($300,000 – $60,000 basis).

RECHARACTERIZING ROTH CONVERSIONS

Fortunately for many taxpayers, the conversion to a Roth IRA is reversible. Reasons to undo a conversion include:

- Unintended financial consequences, as discussed previously in this chapter;
- Higher-than-anticipated taxes on the conversion; and
- Significant decreases in value of the investments after the conversion date.

If the original conversion was from an employer-sponsored plan, taxpayers electing to recharacterize the conversion do not transfer the money back to the employer. Instead the money is transferred to a traditional IRA.[48]

46. IRC §§402(c)(2)(B) and 402(c)(8)(B)(i).
47. IRC §402(c)(2).
48. IRC §408A(d)(6)(A).

Deadline

The 2010 deadline to recharacterize a conversion is **October 17, 2011.**[49] This deadline applies to taxpayers who file timely by April 15, 2011, and taxpayers who file for extensions.

The extended deadline will be particularly important if tax rates for 2010, 2011, or 2012 change significantly after the conversion is made. Since the deadline also applies to elections to include the conversion in 2010 income, if the future tax rates are increased after the tax return is filed but before the deadline, taxpayers may amend the 2010 returns to avoid the additional taxes on the conversion.

> **Note.** The extended deadline may also be a blessing if the stock market plunges between the conversion date and October 2011. If taxpayers suffer permanent decreases in the value of the investments in their Roth IRAs, the savings from undoing the conversion may be substantial.

Separate Roth Accounts

One planning strategy is to make **separate conversions** into different Roth IRAs based on the type of investments to be held in the account. For example, a taxpayer may elect to convert a traditional IRA to two separate Roth IRAs. Roth IRA #1 may be invested in the bond market and Roth IRA #2 may be invested in the stock market.

These markets tend to rise and fall in contrast to each other. Therefore, the taxpayer has one Roth IRA that will probably increase in value and another one that will likely lose value, especially in the short-term. This maximizes the benefit of recharacterization for the losing portfolio.

Reconverting Recharacterized IRAs

To prevent taxpayers from recharacterizing a Roth conversion back to a traditional IRA, then immediately reconverting the same money back into a Roth, the law imposes time restraints on making conversions after a recharacterization. After a recharacterization, the IRA cannot be reconverted to a Roth IRA until the **later** of:

1. The beginning of the tax year **following the tax year** in which the amount was originally converted to a Roth IRA, or
2. The end of the **30-day period** beginning on the day on which the IRA was transferred from a Roth back to a traditional IRA.[50]

> **Note.** For more information on recharacterizations and reconversions, see Chapter 9 in the 2009 *University of Illinois Federal Tax Workbook.* This is available on the accompanying CD.

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49. IRC §408A(d)(7).

50. Treas. Reg. §1.408A-5, Q&A-9.

PROBLEM 3: BASIS FOR LIFE TENANTS AND REMAINDER HOLDERS

BACKGROUND

The cost basis of inherited property is almost always the FMV of the property as of the testator's date of death. However, what is the basis of property when the various rights to the property are not owned by the same people?

> **Note.** The legal term for the person writing a will is **testator**. The word derives from the Latin word *testārī,* which means to make a written document providing for the disposition of property after one's death.[51]

Naming one person to receive the income and/or use of property until death and naming another person to receive ultimate ownership of the property is done for various reasons, as shown in the following examples.

Example 8. Jackie and John were a happily-married couple with two children when John died unexpectedly. Jackie raised the children in the quaint family home she and John had built. At the age of 50, Jackie fell in love with Ari, a young man of humble circumstances. They marry in 2010.

Before the wedding, Jackie revised her will. She leaves the house to her two children. However, to ensure that Ari always has a home, she leaves him the right to live in the house for the rest of his life. Ari's inheritance is often called a **lifetime estate, life estate,** or **life interest**. The children's inheritance is called a **remainder interest.**

Life estates and remainder interests are also used for estate tax planning purposes. The intent of the testator in these circumstances is to effectively use the estate tax exemptions of both the husband and wife.

Example 9. Don owns several rental properties. The properties are worth about $5 million. In his will, Don has provided that properties that are equal in value to the amount of the estate tax exemption will be left to his daughter, Porsche. The balance of the real estate will be left to his wife, Ivy. However, he stipulates that his wife receives all the rental income from the properties that his daughter inherits.

Tax Result A. The estate tax exemption is $2 million when Don dies. Ivy dies later that same year. Don's estate gets the benefit of the $2 million exemption for Porsche's inheritance and the marital deduction for Ivy's inheritance eliminates the remaining $3 million of his taxable estate.

When Ivy dies, their daughter, Porsche, inherits her rental property worth $3 million. Ivy's estate is also allowed a $2 million exemption. The result is that estate taxes are only paid on $1 million of the $5 million properties.

Tax Result B. Don leaves his entire estate instead to his wife, Ivy. There are no estate taxes due from his estate because of the marital deduction. The $5 million value of all of the properties is included in Ivy's estate. Ivy's estate still receives a $2 million exemption. However, Ivy's estate is liable for estate taxes on $3 million instead of $1 million.

> **Caution.** As of the publication date, the laws for estates created in 2010 are expected to change. The facts in **Example 9** may lead to different tax results in 2010 and future years depending on how the estate tax laws are amended.

The remainder holder does not benefit from the property until the life tenant dies. **Therefore, should the cost basis of the property be adjusted when the life tenant dies?** The short answer is **No,** due to the **uniform basis** rules.

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51. [www.thefreedictionary.com] Accessed on May 3, 2010.

UNIFORM BASIS

The general idea of uniform basis is that the cost basis of inherited property should equal the value used for estate tax purposes.[52] The new cost basis after death is usually referred to as the **stepped-up basis**, although the new basis can be lower than the original cost.

The following property is includable in the estate and receives a step up in basis:[53]

- Property acquired from a decedent through a will or under the laws for people dying without a valid will
- Property held by a revocable grantor trust
- Property transferred to a trust if the grantor/decedent reserved the right to alter, amend, or terminate the trust
- Property transferred before death for less than full and adequate consideration

Caution. Annuities and tax-deferred retirement plans **are** includable in the estate, but they **do not receive a step up** in basis.[54]

If a federal estate tax return is not required, all applicable property of the decedent still receives a step up in basis.

Treasury regulations state that the basis of property acquired from a decedent is uniform in the hands of every person having an interest in the property.[55] As explained in the regulations, under the laws governing transfers from decedents, **all** ownership interests relate to the death of the decedent, whether the interests are vested or contingent. Accordingly, there is a common acquisition date and a common basis for life tenants and remainder holders.

APPLICATION OF THE UNIFORM BASIS RULE

The uniform basis rule is easy to implement after the death of the life tenant, as shown in the following example.

Example 10. Boris leaves his entire estate to his son, Rocky, as a remainder holder. However, all income from the estate is payable to his wife, Natasha, until her death. The value of the property is $200,000 at the time of his death.

Natasha collects the income from the inherited property for 20 years. When she dies, the appreciated value of the property is $500,000.

Tax Result. When Natasha dies, Rocky becomes the sole owner of both the property and the future income. However, because Rocky's ownership of the property is based initially on his father's death, Rocky's basis is $200,000, the value at the time his father died.

Observation. This result can also be explained by the **exclusion** of the life interest from Natasha's estate. Since it was **not** includable in her estate, there is no step up in basis to Rocky, the person who receives the right to the income after she dies.

52. Treas. Reg. §1.1014-1(a).
53. Treas. Reg. §1.1014-2.
54. Treas. Reg. §1.1014-2(b)(3)(i).
55. Treas. Reg. §1.1014-4.

If the inherited property is subject to depreciation, the holder of the life interest is allowed to claim the depreciation expense attributable to the entire inherited basis of the depreciable property.

Example 11. Wilma owns an apartment complex in downtown Bedrock. She leaves a life interest in the apartments to her husband, Fred, and the remainder interest to her best friend, Betty. **When Wilma dies, the complex is valued at $600,000.** This value is allocated $100,000 to land and $500,000 to buildings.

Tax Result. Fred's basis in the property for depreciation purposes during his lifetime is $500,000. This is true even though he is not the ultimate owner of the property.[56]

Example 12. The facts are the same as in **Example 11.** Fred lives for 10 years and claims a total of $160,000 in depreciation on the property. He dies in 2010, and Betty acquires the complex.

Tax Result. Betty's adjusted basis in the buildings at the time of Fred's death is the same as Fred's adjusted basis: $500,000 less $160,000 in depreciation, or $340,000. Betty continues the depreciation after Fred's death using Wilma's date of death as the beginning date.[57]

Allocation of the uniform basis between life tenants and remainder holders changes each year. As a life tenant ages, the value of her interest decreases. At any particular time, a life tenant's portion of the uniform basis is equal to the **present value** of the uniform basis. The present value is calculated based on the **life estate factor** found in IRS Pub. 1457, *Actuarial Values*.[58] The remainder holder's basis is the difference between the uniform basis and the amount allocated to the life tenant.

Example 13. In 2010, Bob leaves a life interest in the income from his land in Pekin to Patrick. He leaves the remainder interest in the land to Sandy. **The land is valued at $10 million on Bob's estate tax return.**

Patrick and Sandy agree to sell the inherited land to Eugene in exchange for $11 million. This is a fair exchange.

Tax Result. Patrick and Sandy allocate the $10 million between them for income tax purposes. Patrick's portion is calculated first, since his portion is the life estate. His basis is the **present value of the uniform basis**.[59]

Based on Patrick's age and the appropriate **federal midterm interest rate (FMIR),**[60] the life estate factor for Patrick's ownership interest is .90207. **Patrick reports a basis of $9,020,700 on his tax return against the sales price of his life interest** ($10 million uniform basis × .90207).

Sandy's basis as the remainder holder is the difference between the uniform basis and the amount allocated to Patrick. She reports $979,300 as her cost basis ($10,000,000 less $9,020,700).

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56. Treas. Reg. §1.1014-4(b).

57. Ibid.

58. Treas. Reg. §20.2031-7.

59. Treas. Reg. §1.1014-5(c), Example (4).

60. Treas. Reg. §20.2031-7 references IRC §7520, which defines the appropriate interest rate to be equal to 120% of the federal midterm rate in effect under §1274(d)(1) for the month in which the valuation date falls.

SALE OF ONLY THE LIFE ESTATE INTEREST

The basis rules change dramatically for the holder of a life estate interest if the rights to the income are sold without the remainder interest being sold as part of the same transaction. **If the life interest is sold separately, the seller's basis for tax purposes is $0.**[61]

The buyer of the life interest can amortize the cost of the purchase over the life expectancy of the seller.[62]

> **Example 14.** Bill leaves a life interest in stock to his neighbor, Dale, and a remainder interest to another neighbor, Bobbi. The value of the stock for estate tax purposes is $5,000 at the time Bill dies. Dale immediately sells his life interest to LuAnn for $100.
>
> **Tax Results.** Dale's cost basis in his life interest is $0. Dale reports the gain of $100 on Schedule D, *Capital Gains and Losses,* as a long-term capital gain.[63]
>
> This transaction has no effect on the uniform basis. The cost basis allocable to Bobbi's remainder interest will continue to increase each year as the life interest's value decreases.[64]
>
> LuAnn is entitled to subtract a portion of the $100 she paid Dale each year against her dividend income. The subtraction is based upon Dale's life expectancy at the time of the sale.[65]

Note. There is no authority directing LuAnn where to include this subtraction on her return. The conservative approach is to include it in investment expense on Schedule A, *Itemized Deductions*. An aggressive approach is to treat it in the same way as premiums paid for bonds, which is as a subtraction on Schedule B, *Interest and Ordinary Dividends*.

DEATH OF THE REMAINDER HOLDER[66]

If the holder of the remainder interest dies before the holder of the life interest, **the uniform basis is not adjusted** and the **life tenant's** basis is still calculated as explained previously.

However, the value of the remainder interest **is** included in the estate of the remainder holder. The regulations, therefore, allow the beneficiary of the remainder holder's estate to adjust the basis for a **portion** of the value that is included in the estate.

This **basis adjustment** is calculated by subtracting the portion of the uniform basis allocable to the decedent immediately prior to death from the value of the remainder interest included in the estate.

61. IRC §1001(e).
62. Treas. Reg. §1.1014-5(c).
63. IRC §1223(10).
64. Treas. Reg. §1.1014-5(a)(2).
65. Treas. Reg. §1.1014-5(c).
66. Treas. Reg. §1.1014-8.

Example 15. Marge died in 2006. In her will, she left Bart, her son, a life estate interest in their family home. She left Lisa, her daughter, the remainder interest. In 2010, Lisa is assassinated by a protester against renewable energy. In Lisa's will, Maggie, her sister, is the sole heir. Bart is still alive.

The FMV of the house in 2006 when Marge died was $100,000. At the time of Lisa's death, her share in the uniform basis was $15,000, based on Bart's life expectancy and the FMIR. The value of the home in 2010 when Lisa died was $200,000. The value of the remainder interest included in Lisa's estate was $30,000.

Tax Result. Maggie's basis adjustment in the inherited house is shown below:

Value of the house included in Lisa's estate	$30,000
Less: Lisa's portion of the uniform basis at her death	(15,000)
Maggie's basis adjustment in the house	$15,000

When the beneficiary to the remainder interest sells the property, the basis is calculated using the beneficiary's current portion of the uniform basis **at the time of the sale** plus the adjustment.

Example 16. Use the same facts from **Example 15.** In 2012, Bart is killed while skateboarding at an amusement park. Maggie then decides to sell the house and move to Amsterdam.

Tax Result. Maggie's cost basis in the home is the original uniform basis after Marge's death in 2006, plus the adjustment she received after Lisa's death in 2010.

Original uniform basis following Marge's death	$100,000
Adjustment as a beneficiary of Lisa's estate	15,000
Maggie's adjusted basis in the house	$115,000

Example 17. Use the same facts from **Example 15.** Maggie decides to sell her remainder interest in the house in 2011 before Bart dies.

Tax Result. Maggie's basis is her portion of the original uniform basis at the time of the sale plus the adjustment she received as Lisa's beneficiary.

Original uniform basis following Marge's death	$100,000
Less: Bart's share of the basis based on his current age and the FMIR	(60,000)
Maggie's share of the original uniform basis	$ 40,000
Plus: adjustment as beneficiary of Lisa's estate	15,000
Maggie's adjusted basis for her 2011 sale of the house	$ 55,000

PROBLEM 4: RENTAL REAL ESTATE PROBLEMS

BACKGROUND[67]

In the winter of 2010, the IRS released its preliminary Statistics of Income, which compared 2007 individual returns to 2008 individual returns. According to this report, the number of returns filed **decreased** from 143 to 142 million. However, the number of returns reporting income from rent and royalties **increased** from 9.8 million for 2007 to 9.9 million for 2008. According to these statistics, almost 7% of taxpayers own rental property.

CONVERTING A FORMER RESIDENCE TO RENTAL PROPERTY

There are a number of reasons that people convert their homes to rental property. The decline in the housing market caused some taxpayers to convert their homes to rental properties instead of selling the houses. Some taxpayers rent out their homes while they temporarily work in other geographical areas. Others may see a conversion as an opportunity to deduct a tax loss on the sale of business property versus a nondeductible loss for the sale of a personal residence.

How to Depreciate a Former Residence[68]

Property that is placed in service and taken out of service in the same year cannot be depreciated.[69] Therefore, there is no depreciation deduction for taxpayers who temporarily rent out their homes during the year and stop renting it during the same year.

Residential rental property is depreciated using the mid-month convention, straight-line method over 27.5 years using MACRS general depreciation system (GDS). Depreciation begins when the property is ready and available for rent.

> **Example 18.** Mike and Carol build the perfect new home for their family of eight. It has a master suite, six bedrooms, and a cottage for their live-in housekeeper. Unfortunately, they haven't been able to find a buyer for their former four-bedroom home.
>
> They move into the new home in July. They spend most of August and September repairing the wear and tear on their former home caused by their six children. On October 1, they place rental ads in the local paper. The house is finally rented on December 1.
>
> **Tax Result.** Repairs were completed and the house and available for rent on October 1. Therefore, this is the date depreciation begins.

The basis for depreciation purposes is the **lesser of cost or FMV.** Cost includes the original purchase price, the cash outlay for permanent improvements, and decreases to basis from tax benefits such as residential energy credits.

The FMV is the price at which the property would sell in an arms-length transaction. An arms-length transaction is one involving an unrelated buyer and seller, neither of whom **must** buy or sell, and both of whom have reasonable knowledge of all relevant facts. Sales of similar property, on or about the same date, may be helpful in establishing the property's FMV. Property tax assessments may also be useful in determining FMV.

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67. Parisi, M., "Individual Income Tax Returns, Preliminary Data: 2008" (Winter 2010). *Statistics of Income Bulletin, 29,* p. 6.

68. IRS Pub. 527, *Residential Rental Property* (2009).

69. Treas. Reg. §1.168(d)-1(b)(3)(ii). See also IRS Pub. 946, *How to Depreciate Property* (2009).

Example 19. Herman accepts a promotion that will involve relocating his family to Buffalo. Mr. and Mrs. Addams offer to rent Herman's home as a playhouse for their children. At the time the Addams family takes possession of the home, it is **worth $80,000** according to the tax assessor's office.

Herman and his wife, Lily, purchased their home on Mockingbird Lane in 1964 for $13,000. Over the years, they have made significant improvements, including a handicapped-accessible dungeon and a state-of-the-art laboratory. The roof has been replaced several times after explosions from Grandpa's experiments going awry. Lily provides their tax accountant with the following information to calculate the cost basis.

Original purchase price (1964)	$13,000
Kitchen remodel (1968)	2,000
Landscaping (2009)	4,000
Dungeon addition (1970)	8,000
Laboratory remodel (1972)	13,000
Roof replacement (1966)	500
Roof replacement (1973)	800
Roof replacement (1996)	5,000
Total cost of home	**$46,300**

Tax Result. The property's FMV is $80,000 and the family's investment is $46,300. The lesser of the two is cost. However, not all of the costs can be included in the depreciable basis of the home. After discussing the nature of the improvements and repairs with the couple, their tax advisor computes the depreciable cost of the home as shown below.

Original purchase	$13,000
Less: lot value at time of purchase	(1,000)
Kitchen remodel	2,000
Dungeon addition	8,000
Laboratory remodel	13,000
Roof replacement (1996)	5,000
Total depreciable basis of home	**$40,000**

Only the final roof replacement can be included in the depreciable basis. In addition, to be considered an improvement instead of a repair, the replacement must significantly add to the value of the property or prolong its life. In this case the new metal roof with a 30-year warranty was a significant improvement to the previous asphalt-shingled roof.

The $4,000 for landscaping is a separate depreciable item from the residence. This $4,000 cost is depreciated using MACRS half-year/mid-quarter convention, 150% declining balance, over 15 years.

Selling Rental Property That Was Previously a Main Home

The tax treatment of the sale depends on the following factors:

1. Does the property meet the IRC §121 exclusion tests for gain realized on the sale of a main home?
2. Was the property sold at a gain or a loss?

Property Qualifies as Principal Residence and Sold at a Gain. A taxpayer may exclude up to $250,000 of gain on the sale of a principal residence if the home was owned and used as the taxpayer's principal residence in two out of the last five years ending on the date of the sale.[70] However, any gain attributable to nonqualified use after December 31, 2008, is taxable. Nonqualified use does not include any period after the last date the property is used as the principal residence by the taxpayer or spouse. In addition, any depreciation allowed or allowable after May 6, 1997, is taxable up to the amount of the gain.

5

Example 20. Hank and Peggy purchased their Texas residence on July 1, 1990, for $40,000. On June 30, 2009, they relocated to Lexington, North Carolina, where Hank was appointed commissioner of the annual Lexington Barbeque Festival. Unsure if they could be happy outside of Texas, they advertised the Texas house for rent on July 1, 2009. At that time, the property's FMV was $80,000.

The depreciable basis in their home is calculated as shown.

Lesser of cost ($40,000) or FMV ($80,000)	$40,000
Less: lot value at time of purchase	(4,000)
Depreciable basis of Texas home	**$36,000**

On their 2009 and 2010 tax returns, they claim a total of $1,855 in depreciation. On December 31, 2010, the house is sold for $90,000 to the Landry Memorial Committee, which plans to convert the house to a tourist attraction devoted to Tom Landry.

Tax Result.

Step 1. Hank and Peggy's tax preparer first calculates the adjusted basis.

Original cost	$40,000
Less: depreciation claimed	(1,855)
Adjusted basis	**$38,145**

Step 2. Next, total gain is calculated.

Sales price	$90,000
Less: adjusted basis from Step 1	(38,145)
Total gain realized	$51,855
Less: §121exclusion	(50,000)
Total gain recognized	**$ 1,855**

Because Hank and Peggy met the two-out-of-five-year test and used the home as a principal residence after December 31, 2008, there is no nonqualified usage for the subsequent period when it was used as a rental property. Thus, the only gain recognized is the unrecaptured §1250 depreciation of $1,855.

The excludable portion of $50,000 is shown in Part I of Form 4797, *Sales of Business Property*. The description on line 2(a) is **§121 exclusion** and the excluded amount is entered on line 2(g).[71] The sale is reported in Part III. The completed form follows.

70. IRC §121.

71. Instructions for Form 4797, *Sales of Business Property* (2009).

For Example 20

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

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184 — 2010 — Attachment Sequence No. 27

Name(s) shown on return: **Hank & Peggy** — Identifying number: **333-33-3333**

1 Enter the gross proceeds from sales or exchanges reported to you for 2010 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) . . . . | 1 | **90,000**

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

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
Sec. 121 exclusion	07/01/90	12/31/10				(50,000)

3	Gain, if any, from Form 4684, line 42	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft.	6	51,855
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	1,855

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

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

8 Nonrecaptured net section 1231 losses from prior years (see instructions) . . . . | 8 |

For Example 20

Form 4797 (2010) Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Residential real estate	07/01/1990	12/31/2010
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	90,000			
21 Cost or other basis plus expense of sale	21	40,000			
22 Depreciation (or depletion) allowed or allowable	22	1,855			
23 Adjusted basis. Subtract line 22 from line 21	23	38,145			
24 Total gain. Subtract line 23 from line 20	24	51,855			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a	0			
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c	51,855			
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	0			
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	51,855
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	0
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 36. Enter the portion from other than casualty or theft on Form 4797, line 6	32	51,855

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2010)

5

Property Sold at a Loss. Generally, a loss on the sale of personal property **is not** deductible.[72] However, a loss on the sale of income-producing property **is** deductible.[73] There is no definitive rule that specifies when a former residence becomes rental property for purposes of claiming a loss when it is sold. According to the Tax Court, this determination is based on the facts and circumstances surrounding the sale:

> *Whether a former residence used for personal purposes has been converted in the hands of the same taxpayer to property held for the production of income is a question of fact to be resolved with reference to the surrounding facts and circumstances. . . Five factors have been identified by this Court and other Federal Courts in deciding previous cases involving similar questions; those* ***factors include****:*
>
> 1. *The length of time the house was occupied by the individual as his residence before placing it on the market for sale;*
> 2. *Whether the individual permanently abandoned all further use of the house;*
> 3. *The character of the property (recreational or otherwise);*
> 4. *Offers to rent; and*
> 5. *Offers to sell.*
>
> *. . .* ***No one factor is determinative; rather, all the facts and circumstances must be considered.*** *(emphasis added)*[74]

The amount of deductible loss is also limited to the loss incurred during the period the property was held for production of income.[75] This occurs when the FMV at the time of conversion is less than the cost basis. The depreciation schedule should show the correct basis to calculate the deductible loss, since the depreciable basis is the lesser of cost or FMV.

Example 21. Jethro purchased a condominium in Beverly Hills, California, in 1999 for $300,000. He lived in the home until December 31, 2006, when he moved to Pigeon Forge, Tennessee, for a job opportunity at Dollywood.

At the time of the move in 2006, the condo's FMV was only $200,000. Jethro refused to list the property for sale, despite advice he received from his real estate agent, Mr. Drysdale. Jethro believed that the value would increase. His friend, Jane, agreed to manage the condo as a rental property. It was first rented in January 2007. The renter was not related to Jethro and the rent charged was the fair rental value.

Unfortunately, the Beverly Hills' property values continued to decline. In August 2010, Jethro sells the condo for $150,000.

Tax Result. Jethro's tax advisor determines that the condo was fully converted to rental in January 2007. Therefore, the 2010 sale is a sale of business use property and the loss is deductible. This sale is reported in Part I of Form 4797. The deductible loss calculation is shown on the next page.

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72. Treas. Reg. §1.262-1(b)(4).

73. IRC §1231.

74. *Philip A. Saunders v. Comm'r,* TC Memo 2002-143 (June 10, 2002).

75. IRS Pub. 544, *Sales and Other Dispositions of Assets* (2009).

Calculation of adjusted basis	
Lesser of cost/FMV on date converted to rental property (January 2007)	$200,000
Less: depreciation allowed or allowable (2007 through 2010)	(26,061)
Adjusted basis at time of sale	**$173,939**
Calculation of deductible loss	
Sale price	$150,000
Less: adjusted basis	(173,939)
Deductible loss (Part I of Form 4797)	**($23,939)**

Observation. The condo was rented over three and a half years (January 2007 through July 2010). Therefore, it is clear that it was actually converted to rental property. The loss of $23,939 incurred during the rental period is fully deductible. However, the $100,000 loss incurred during the time Jethro lived in the condo is not deductible.

LIMITATIONS ON DEDUCTIONS FOR REAL ESTATE NOT RENTED FOR PROFIT

Rental activities must be operated with a profit motive for the losses to be deductible. If a property is used partly to generate income and partly for personal purposes, the amount of deductible expenses may be limited.

The instructions for Schedule E, *Supplemental Income and Loss*, identify the following people whose use is considered **personal use by the taxpayer:**

- The taxpayer, if the property is occupied for personal purposes
- Any other person that owns part of the unit and uses the property for personal purposes, unless rented to that person under a "shared equity" financing agreement
- Anyone in the taxpayer's family, unless the unit is rented at a **fair rental price** to that family member as his or her main home
- Anyone who pays **less than a fair rental price** for the unit
- Anyone under an agreement that lets the taxpayer use some other unit

It is very common for taxpayers to "rent" to members of their family. Unless the family member is charged the fair rental price for the property, the family member's use is considered personal use by the taxpayer.

The IRS instructs taxpayers who rent property without intending to profit to report the income on **line 21, *Other Income*, on page 1 of Form 1040.**[76] Related expenses are deducted on **Schedule A, *Itemized Deductions*.**

76. IRS Pub. 527, *Residential Rental Property,* p. 17 (2009).

Deduction Limitations by Category[77]

Category	Type of Expenses	Where Deducted
1	Real estate taxes, mortgage interest, casualty losses	Designated lines on Schedule A
2	Other expenses not in Categories 1 or 3	Miscellaneous subject to 2% floor
3	Depreciation and amortization	Miscellaneous subject to 2% floor

Category 1 deductions are not limited by the not-for-profit rules, but they are subject to the limitations applicable to that type of expense. For example, the 10% AGI limitation applies to all personal casualty losses including those connected with property rented without a profit motive.

Category 2 deductions cannot exceed the profit remaining after Category 1 expenses are subtracted from rental income.

Category 3 deductions cannot exceed the profit remaining after expenses from the previous categories are subtracted from the rental income.

Example 22. Frank dotes over his granddaughter Ally. Ally has two small children and works as a waitress while her children are in school. When Frank moved to Florida in 2008, he let Ally and the children move into his former home. He charges her $200 per month in rent to help offset the cost of the real estate taxes and insurance. In 2010, the real estate taxes are $2,000 and the insurance is $800.

Tax Result. For 2010, Frank reports $2,400 ($200 × 12 months) of rental income on line 21, *Other Income*, of his 1040. The allowable deductions on Schedule A are calculated as shown:

Total rental income	$2,400
Less: deductible real estate taxes	**(2,000)**
Remaining profit for category 2 and 3 expenses	$ 400
Lesser of remaining profit ($400) or Category 2 expenses ($800 insurance)	**(400)**
Remaining profit available for Category 3 expenses (depreciation)	**$ 0**

Frank deducts $2,000 on the real estate tax line of Schedule A and $400 of the insurance expense as a miscellaneous itemized deduction subject to the 2% floor. He does not deduct any depreciation since there is no profit remaining after the Category 1 and 2 expenses are deducted.

Observation. Reporting the $2,400 rental income on line 21 increases Frank's 2010 AGI. This may cause adverse tax consequences, especially if he cannot itemize.

There is a fine line between reportable income and reimbursement for out-of-pocket expenses. If Frank and Ally's agreement defines her payments to him as reimbursements, Frank could argue that none of the payments are includable in income. This argument is supported by court cases such as *Comm'r v. Glenshaw Glass Co.,*[78] which defined gross income as "an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion."

It is also supported by the IRS conclusion in a chief counsel advice ruling.[79] It held that a taxpayer who receives a property tax rebate of real property taxes in the same tax year the real property taxes were paid is not required to include the rebate in gross income in the year received, except to the extent, if any, that it exceeds the real property tax paid by the taxpayer.

If Frank takes this position, he must reduce his deductions by any reimbursements received. **A tax practitioner taking this position should consider disclosing the position to avoid any potential preparer penalties if the treatment is disallowed in an audit.**

77. IRS Pub. 535, *Business Expenses,* p. 5 (2009).

78. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 1955-1 CB 207.

79. CCA 200721017 (Feb. 8, 2007).

HUSBAND-WIFE QUALIFIED JOINT VENTURES

The 2009 instructions for Schedule E include some confusing directions for jointly-owned rental real estate, and some tax software programs generate errors if the user indicates that Schedule E property is jointly owned. The instructions read:

> ***Do not use Schedule E to report income and expenses from a rental real estate business that is a qualified joint venture conducted by you and your spouse, if you file a joint return for the tax year.***
>
> *Generally, if you and your spouse jointly own and operate an unincorporated **business** and share in the profits and losses, you are taxed as a partnership. However, if you and your spouse each materially participate as the only members of a jointly owned and operated business, and you file a joint return for the tax year, you can make an election to be treated as a qualified joint venture instead of a partnership. For an explanation of "material participation," see the instructions for Schedule C, line G, on page C-3.*
>
> *To make the election, you must divide all items of income, gain, loss, deduction, and credit attributable to the business between you and your spouse in accordance with your respective interests in the venture. **Each of you must file a separate Schedule C or C-EZ.** On each line of your separate Schedule C or C-EZ, you must enter your share of the applicable income, deduction, or loss. See the instructions for Schedule C or C-EZ and Publication 527 for more details. As long as you remain qualified, your election cannot be revoked without IRS consent.*
>
> ***Note. Rental income reported on Schedule E is not taxable for self-employment tax purposes. Electing qualified joint venture status and using the Schedule C or C-EZ does not alter the application of the self-employment tax or the passive loss limitation rules.*** (emphasis added)

The following is the probable IRS reasoning for these Schedule E instructions:

- Partnership returns are required for most joint ventures.
- The IRC exempts husband-wife joint ventures from partnership treatment if each spouse reports "such spouse's respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor."[80]
- Therefore, rental real estate activities owned jointly by spouses should be reported on Schedule C.

However, Treasury regulations[81] provide another exception to partnership treatment for **participants in an investment activity who can accurately compute their income without filing a partnership return.** To qualify, the participants must:

1. Own the property as co-owners;
2. Reserve the right separately to take or dispose of their shares of any property acquired or retained; **and**
3. Not actively conduct a business or irrevocably authorize another person to purchase, sell, or exchange the investment property.

The regulations explain how to properly make the election for such treatment. However, they also provide that a venture is deemed to have made the election "if the members of the organization owning substantially all of the capital interest report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization."[82]

80. IRC §761(f)(1)(C).

81. Treas. Reg. §1.761-2.

82. Treas. Reg. §1.761-2(b)(2)(ii)(b).

The IRS Schedule E instructions state that the rental activity is not subject to SE tax even when reported on Schedule C. However, if a profitable rental activity is reported on Schedule C and no SE tax is paid, the taxpayer may receive an error notice from the IRS. The instructions for Schedules E, C, and SE all indicate the income is exempt from SE tax, but none say how it should be marked to avoid a letter from the IRS indicating an error was made in calculating SE tax. **However, there is a check-box on both the Schedules C and CZ indicating the rental income is not subject to SE tax.**

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

Profit or Loss From Business
(Sole Proprietorship)
▶ Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B.
▶ Attach to Form 1040, 1040NR, or 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
2009
Attachment Sequence No. 09

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see page C-2 of the instructions) | **B Enter code from pages C-9, 10, & 11** ▶

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN), if any**

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

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

G Did you "materially participate" in the operation of this business during 2009? If "No," see page C-3 for limit on losses ☐ Yes ☐ No

H If you started or acquired this business during 2009, check here ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** See page C-4 and check the box if: • This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or • You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses. ▶ ☑	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see page C-4)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	

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

8 Advertising . . . 8 | 18 Office expense . . . 18

PROPERTY RENTED ON AVERAGE FOR 7 DAYS OR LESS

Exception to $25,000 Special Allowance for Rental Real Estate Activities

Generally, deductions for losses from passive activities are limited to income from passive activities. However, most taxpayers who **actively participate** in rental real estate activities may deduct up to $25,000 of related passive losses against other types of income.[83]

Not all rental activities qualify for the special allowance. To qualify, one of the following two tests must be met:

1. The property must be rented for **more than seven days on average per customer during the year.**
2. The taxpayer must **materially participate** in operation of the rental activity.

If the taxpayer does **not** meet at least **one** of these tests, deductible losses are limited to the amount of income from other passive activities.[84]

83. IRC §469(i).

84. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(A).

Average Rental Test. The average period of customer use is calculated by dividing the total number of days in all periods of customer use during the year by the number of periods of customer use. Each period during which a customer has a continuous or recurring right to use the property is a separate period of customer use.[85]

Caution. This is not the only rental activity that does not qualify for the special allowance. See pages 34–41 of the 2004 *University of Illinois Federal Tax Workbook* for more examples. This material can be found in the Federal Tax Workbook archive at **www.TaxSchool.illinois.edu/taxbookarchive**.

Material Participation Test. Material participation is defined as involvement in the operations of an activity on a regular, continuous, and substantial basis.[86] A taxpayer can establish material participation for a tax year by **satisfying one** of seven tests included in the Treasury regulations:[87]

1. The taxpayer spends more than 500 hours participating in the activity.
2. The taxpayer performs substantially all the work involved in the activity including work done by individuals who are not owners.
3. The taxpayer spends more than 100 hours participating **and** no one else works more hours than the taxpayer.
4. The taxpayer spends more than 100 hours participating **and** the taxpayer's aggregate participation in all similar activities during the year exceeds 500 hours.
5. The taxpayer materially participated in the activity for any five taxable years during the 10 taxable years that immediately precede the taxable year.
6. The activity is a personal service activity **and** the individual materially participated in the activity for **any** three taxable years preceding the taxable year.
7. Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during the year.

85. Treas. Reg. §1.469-1(e)(3)(iii).
86. IRC §469(h)(1).
87. Temp. Treas. Reg. §1.469-5T.

Example 23. Gomer earns $66,000 per year as a First Sergeant with the U.S. Marines. While on leave in Florida in December 2009, he bought a beach house. It will be a perfect place for him to live when he retires. In the meantime, he hires a local management company to oversee the property. He knows that the rental income will not be sufficient to cover the costs of owning the property, but he expects the value to increase substantially. He also expects substantial tax savings from deducting the operating losses.

In 2010, the beach house is rented to the following people.

Renter	Dates	Number of Days
Vince	February 13–26	14
Duke	May 25–31	7
Chuck	July 2–5	4
Duke	November 11–13	3
Total rental periods	4	28

Vince spends five days at Disney World during the period he rents the property. Although he does not use the beach house at all during those five days, they count as rental days because he paid for the right to use the property during that time. Duke's rentals count as two separate periods since the dates are not consecutive.

Gomer does not stay at the beach house in 2010. He spends about 60 hours total during the year paying bills and corresponding with the management company. His mortgage interest, real estate taxes, management fees, insurance, repairs, and depreciation **exceed** his 2010 rental income by $10,000. He has no other sources of income in 2010 except his Marine wages.

Tax Result. Gomer fails both qualifying tests for the special allowance. His average rental period per customer is seven days (28 days ÷ 4 rental periods), and he does not materially participate in the operation of the rental activity. Therefore, he does not qualify for the $25,000 special allowance. **Gomer's $10,000 loss for 2010 is suspended until a future year** when he has sufficient passive income to absorb the loss.

Observation. If the property had been rented for **more** than seven days on average per renter, he would qualify for the $25,000 special allowance for rental real estate activities. This is true even though he failed the material participation test.

Conversely, he would also qualify if he **materially participated** in the rental activity even though the property was rented for an average of only seven days per customer.

Note. See *Charles M. Akers, Jr. v. Comm'r* (TC Memo 2010-85) in Chapter 14, Rulings and Cases. The Tax Court in this case found that the taxpayer did not meet either test. The court also concluded that based on the taxpayer's personal use of the property, the property was a personal residence and disallowed all the Schedule E rental expenses.

PROBLEM 5: PASSIVE ACTIVITY GROUPINGS

BACKGROUND

On January 6, 2010, the IRS issued **Rev. Proc. 2010-13,**[88] which sets forth the rules for reporting how passive activities are grouped. **These rules are effective for all tax years beginning on or after January 25, 2010. For calendar-year taxpayers, the rules are effective beginning in 2011.** They do not apply to real estate professionals.[89] Special disclosure rules apply to partnerships and S corporations.

A taxpayer is not required to report any grouping made prior to the effective date of this revenue procedure unless the taxpayer makes a change to the grouping. For changes and new groupings, the rules require that taxpayers disclose which activities have been grouped as a single activity. Failure to disclose the information results in the unreported activities being treated as **separate activities** under a default rule.

Generally, passive activity losses (PAL) in excess of passive activity profits are **suspended** and carried forward to future years until they can be absorbed by excess passive profits. Credits attributable to passive activities are also **suspended** until they can be applied against regular income tax on passive activity profits.[90] However, suspended PAL/credits may be used against nonpassive income/tax when the taxpayer disposes of the entire passive activity to an unrelated party in a fully taxable transaction.[91]

ACTIVITY GROUPING

How activities are grouped is important for several reasons. Grouping several activities together as one activity may allow a taxpayer to meet the material participation rules and thereby avoid having the activities classified as passive. However, it may be harder for the taxpayer to meet the material participation test for a particular activity if it is grouped with others.

> **Note.** The **seven tests for material participation** are listed under the topic "Property Rented on Average for 7 Days or Less" in the Problem 4 section of this chapter.

Example 24. Will earns a substantial salary working 60 hours per week as an attorney for the town's leading legal firm. He dreams of a day when he will make a fortune with no effort. He has two business ventures which he hopes will become cash cows, but both are currently money pits.

He **meets** the test for material participation for Venture 1 because he works 110 hours per year managing it, and no one else spends any time on it. He **does not** meet the test for material participation for Venture 2 because he spends 50 hours per year managing it, and his friend, Grace, works 200 hours per year on it. If the activities are grouped, his 160 hours per year are less than Grace's 200 hours. Therefore, if grouped, both activities are passive, and the losses are suspended.

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88. Rev. Proc. 2010-13, 2010-4 IRB 329.
89. See Treas. Reg. §1.469-9.
90. IRC §469.
91. IRC §469(g)(1)(A).

Example 25. Mitch, a doctor, owns three apartment buildings. He earns $500,000 per year. On his 2000 return, he elected to treat the three rental real estate activities as a single passive activity. He does not qualify as a real estate professional.

His suspended passive loss carryover to 2010 is $90,000 for the rental activity. In 2010, he sells one of the apartment buildings to an unrelated person. He realizes a loss of $10,000 on the sale. He also incurs a $2,000 operating loss on the three apartment buildings for the year.

Question 31A. Does the sale of the apartment building in 2010 release the $90,000 of suspended losses?

Answer 31A. No. Mitch made a prior election to treat the three apartment buildings as a single passive activity. The suspended losses won't be released until **substantially all** of the activity is completely disposed of to an unrelated party in a fully taxable transaction.

Question 31B. Will Mitch be able to deduct the $10,000 loss in 2010 on the sale of the building?

Answer 31B. No. This loss is also suspended. The loss will be released when he has sufficient passive income to absorb it or he sells the remaining properties.

Question 31C. If Mitch had **not made the election** to treat the three properties as a single activity, would the sale of one apartment building in 2010 trigger the release of the $90,000 of suspended losses?

Answer 31C. Not the whole $90,000. Mitch is entitled to deduct the portion that relates to the building that is sold. He also can deduct the $10,000 loss on the sale and the portion of the 2010 operating loss attributable to that apartment building.

Question 31D. If Mitch had sold the apartment building for a gain, would that change the tax result?

Answer 31D. Yes. The gain would qualify as income from a passive activity. The current-year operating loss and the suspended losses from prior years would be allowed up to the amount of the 2010 gain.

Note. See pages 627–628 in the 2006 *University of Illinois Federal Tax Workbook* for more information regarding this election. This can be found on the accompanying CD.

The general rule for grouping activities is that the group must constitute an appropriate **economic unit** for measurement of gain or loss under the PAL rules.[92] An **appropriate economic unit** is determined by the facts and circumstances related to the activities. The following five factors are given the greatest weight in making this determination:[93]

1. Similarities and differences in the activities
2. Extent of common control
3. Extent of common ownership
4. Geographical location
5. Interdependencies among the activities, including:
   - Purchasing or selling goods between the activities,
   - Having products or services that are normally provided together,
   - Having the same customers,
   - Having the same employees, and
   - Being accounted for with a single set of books and records

92. Treas. Reg. §1.469-4(c)(1).

93. Treas. Reg. §1.469-4(c)(2).

C corporations, S corporations, and partnerships must group their activities under these rules. Once an entity groups its activities, a shareholder or partner may group those activities with each other, with the activities conducted directly by the shareholder or partner, and with activities conducted through other entities. However, the shareholder or partner may **not separate activities grouped together by an entity**.[94]

Once a taxpayer has grouped activities, the taxpayer generally may not regroup those activities in subsequent taxable years.[95] However, if a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities.[96] A taxpayer must comply with disclosure requirements with respect to both the original groupings and the addition and disposition of specific activities within those existing groupings in subsequent taxable years.

The IRS may regroup a taxpayer's activities if the grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping is to circumvent the PAL rules.[97]

DISCLOSURE REQUIREMENTS FOR ALL TAXPAYERS

New Groupings

A taxpayer must file a written statement with the original income tax return for the first taxable year in which two or more activities are originally grouped as a single activity. This statement must identify the names, addresses, and employer identification numbers, if applicable, for activities that are being grouped as a single activity. In addition, any statement reporting a new grouping must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469.

Addition of New Activities to Existing Groupings

If a taxpayer adds a new activity to an existing grouping, the taxpayer must file a written statement with the original income tax return for that taxable year. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the new activity **and** the activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469.

Regroupings

If the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities. If such a regrouping is made, the taxpayer must file a written statement with the taxpayer's original income tax return for the taxable year in which the activities are regrouped. **The statement must contain an explanation of why the taxpayer's original grouping was inappropriate or the nature of the change that makes the original grouping clearly inappropriate.**

This statement must also identify the names, addresses, and employer identification numbers, if applicable, for all of the activities that are being regrouped. In addition, if two or more activities are regrouped into a single activity, the statement reporting a regrouping must contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469.

94. Treas. Reg. §1.469-4(d)(5).

95. Treas. Reg. §1.469-4(e)(1).

96. Treas. Reg. §1.469-4(e)(2).

97. Treas. Reg. §1.469-4(f).

GROUPINGS BY PARTNERSHIPS AND S CORPORATIONS: SPECIAL RULES

Partnerships and S corporations must comply with the disclosure requirements for grouping activities that are described in the instructions for Form 1065, *U.S. Return of Partnership Income*, and Form 1120S, *U.S. Income Tax Return for an S Corporation*, respectively. Generally, the entity's groupings must be disclosed to the owner(s) on attachments to the entity's annual Schedule K-1 by separately stating the amounts of income and loss for each grouping conducted by the entity.

The Schedule K-1 recipient is not required to make a separate disclosure of the groupings already disclosed by the entity **unless** the recipient groups:

- Any of the activities of the issuing entity that the entity did not group together,
- The entity's activities with activities conducted directly by the recipient, **or**
- The entity's activities with activities conducted through other entities.

FAILURE TO REPORT

If a taxpayer fails to report which activities have been grouped as a single activity, then each activity is treated as a separate activity for purposes of applying the PAL limitation rules. However, a timely disclosure shall be **deemed made** by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping and who makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer.

If the failure is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the disclosures. Although the default rule generally results in unreported activities being treated as separate activities, the IRS may still regroup a taxpayer's activities to prevent tax avoidance.

> **Note.** Chapter 14, Rulings and Cases, discusses the *Ajah* case, which deals with the grouping election.