2016-2017 FEDERAL INCOME TAX LAW COURSE

DESKBOOK

ADMINISTRATIVE AND CIVIL LAW DEPARTMENT

The Judge Advocate General's School
United States Army
Charlottesville, Virginia

2016-2017 FEDERAL INCOME TAX LAW DESKBOOK

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CHAPTER A

COMMUNICATING WITH THE IRS

I. REFERENCES.

A. Primary.

1. Internal Revenue Code of 1986 (26 U.S.C. 1 et seq.).

2. United States Tax Court Rules of Practice and Procedure.

B. Secondary.

1. IRS Pub. 1, Your Rights as a Taxpayer.

2. IRS Pub. 5, Your Appeal Rights and How to Prepare a Protest if you Don't Agree.

3. IRS Pub. 556, Examination of Returns, Appeal Rights and Claims for Refund.

4. IRS Pub. 594, The IRS Collection Process.

5. IRS Pub. 947, Practice Before the IRS and Power of Attorney.

6. IRS Pub. 1035, Extending the Tax Assessment Period.

7. Treasury Department Circular No. 230, Regulations Governing the Practice before the Internal Revenue Service.

8. IRS Notice 746, Information About Your Notice, Penalty and Interest.

II. INTRODUCTION.

III. GETTING STARTED

A. Review the Taxpayers Records.

1. Organize the Data and Create a Retrievable Records System.

a. Tax Returns. In most cases you will need copies of State and Federal returns filed both before and after the return in controversy.

b. IRS Correspondence. Is this the first Notice? Has the issue been previously raised/resolved/disputed? Is the current problem part of a more significant issue?

c. Client Correspondence. Is the client presently represented? What position has the client or the client's representative previously taken?

2. Obtaining the Taxpayer's Computer File. (Note: you may need to create an account with IRS e-Services in order to access the online tools for tax professionals.) The Taxpayer is entitled to a transcript of the taxpayer's account. This document shows the dates the IRS claims the return was filed and the dates of the assessments of penalties, interest and any payments credited to the account. These may be requested and received online or requested online and mailed to the taxpayer (see http://www.irs.gov/Individuals/Order-a-Transcript). The IRS will mail these within 5-10 days to the address they have on file for the taxpayer.

3. Obtaining Income Information. The Information Returns Program (IRP) will provide all data the IRS has with regard to income reported to the taxpayer on Forms W-2, 1099 and the like. This information can be matched against the taxpayer's records for an initial discrepancies check.

4. Obtaining Tax Returns. The IRS will provide a free Tax Return Transcript or summary of the tax return. This form shows most line items on the tax return filed, including any accompanying forms or schedules. It does not include any changes the taxpayer or the IRS made after the return was filed. These may be requested and received by mail. The IRS will mail these within 5-10 days to the address they have on file for the taxpayer. A tax account transcript will show any later adjustments made after the return was filed. IRS Form 4506T-EZ is method to request this information by mail. The Form 4506 (not Form 4506T-EZ) allows the taxpayer to request an actual photocopy of the return at a fixed charge. While the photocopy may be helpful, it seldom provides any additional information not found on the transcript.

5. Obtaining IRS Files. Freedom of Information Act requests can be helpful in obtaining notes, work papers, computations and opinions of any agents working the case. My experience has been that these are seldom provided in a timely fashion and are often so redacted as to be of little use. Appeals to the IRS FOIA Appeals office in Washington D.C. are seldom answered quickly.

B. Understanding the Issues.

1. Usually based on a CP, ACS, or SFR notice. Go to the Understanding Your IRS Notices page and review the advice on methods of disagreement and the substantiation required to resolve the disagreement.

2. Determine the best method of communication.

a. Telephone/Client. In very simple cases the client armed with the issues and the elements of resolution can call the IRS at the number provided on the notice, provide the requested data and, resolve the misunderstanding. In more complicated cases, the client can call the IRS from the attorney's office. This would better inform the attorney as to any further matters in dispute or any further substantiation that may be required.

b. Telephone/Attorney. The attorney would obtain an executed Form 2848, fax the Power of Attorney to the servicing Practitioner Priority Service support line (PPS at 1-866-860-4259 (voice – call for fax number)), and request assistance with regard to the taxpayer's account related issue. This is a service staffed by IRS customer service representatives specially trained to handle practitioner's questions. They will not field questions from the taxpayer and will only interact with a taxpayer's representative.

c. Letter/Client. In the initial stages of correspondence, it is best to have the client sign and send the reply. It shows personal responsiveness to the notice, reserves elevation to the attorney/practitioner level for later stages of the dispute and, creates the groundwork for any subsequent averment of *IRS nonresponsiveness*. It avoids the requirement for a Power of Attorney and keeps the case posted to the taxpayer's address. The attorney should have a series of template replies which identify the issue, provide the answer and avoid any emotional comment. Never allow the taxpayer to leave the office, compose the letter and post it without your review.

d. Letter/Attorney. Each case will dictate the proper time for attorney involvement. It is not unreasonable to have the client post several letters to the IRS. Statutes of Limitation, unabashed noninvolvement by the IRS, interaction with current year returns, and the size of the amounts in dispute may accelerate the process. As a practical matter, I have found that the IRS does not respond a great deal quicker or a great deal more sensitively to my correspondence.

IV. TOOLS OF THE TRADE

A. IRS Form 2848. Power of Attorney and Declaration of Representative. Advise the taxpayer that this document allows you to receive and inspect confidential tax information and to sign any agreements and consents. The taxpayer can authorize additional acts but this is seldom required. The power of attorney remains in effect until a new one is posted. Future notices and communication will be sent to the taxpayer with a copy to the attorney in fact. The taxpayer should advise the attorney of any change of address and the attorney should advise the taxpayer of any change of assignment. The IRS usually will accept a power of attorney that is submitted to them by facsimile transmission.

NOTE: Once the IRS receives a Power of Attorney, until it is revoked, they cannot contact the taxpayer directly but will only work through you as the representative. Therefore, it is good practice to write the word "Revoked" across the face of Page 1 of the Power of Attorney and fax both pages of the Power of Attorney to the IRS upon completion of your representation of the client.

B. IRS Form 8821. Tax Information Authorization. This form authorizes someone to receive confidential tax information. It is commonly used in cases of security clearances and bank loans. It cannot be used to name an individual to represent a taxpayer before the IRS. Similarly, it does not allow you as the attorney to advocate a position on behalf of a client.

C. IRS Form 911. Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order). This is a form posted to the Taxpayer Advocate to request relief where either a significant hardship is involved or when the IRS has failed to respond to the taxpayer or the taxpayer's attorney. In practice, the taxpayer is asking the Taxpayer Advocate's office to get the IRS center to respond to, resolve or remand the problem to the appropriate department.

D. IRS Form 1040X. Amended U.S. Individual Income Tax Return. In many cases the eventual resolution of a dispute will require certain changes to the original, previous and, subsequent tax returns. Additionally, changes may be required on State and Municipal returns. In these cases, check for the appropriate State or Municipal form or prepare a corrected basic return annotated with the phrase "Amended Return" and, attach a copy of the Federal Form 1040X.

V. RESOLUTION TECHNIQUES

A. Talking to all of the players.

1. Taxpayer prepared return. You'll save a lot of time and energy if you meet with the taxpayer that actually prepared the return. The spouse that keeps the household records or the spouse that was available for the appointment or the child whose parent prepared the return are all going to balk at the significant questions you pose. Hours can be wasted trying to calculate basis or useful life where the preparer has the information at their fingertips.

2. Tax Center prepared return. A call to the Tax Center might prove rewarding. While Tax Center personnel tend to be transient, offices often retain previous years returns. Additionally, someone at the Tax Center may be attempting to assist or contact the taxpayer on the issues in dispute.

3. Commercially prepared returns. The taxpayer may have paid for some sort of audit assistance or penalty and interest insurance. Most contractual provisions require the taxpayer to promptly notify the preparer of any IRS notice.

***PRACTICE POINTER*:** Often, taxpayers will identify themselves as being completely perplexed by the IRS notice. This is usually brought on because they didn't really read the letter. Taxpayers tend to very rapidly peruse the letter until they get to the "Amount Due" part. Don't make the same mistake. Think back to the days of highlighting Case Books. Each Notice will identify the taxpayers, tax year, tax identification numbers, tax entries in question and the available methods of dispute. Compare all of this data with the original return before attempting to explain the matter to the taxpayer.

VI. REQUESTING RELIEF.

A. IRS notices commonly ask the taxpayer to characterize his position with regard to the issue.

1. Fully agree with the notice. There is no issue in controversy. The taxpayers may wish to have the interest abated. The IRS Restructuring and Reform Act of 1998 requires the IRS to notify taxpayers of proposed discrepancies within 18 months of the original filing date in order to charge interest. Additionally, the Tax Reform Act of 1986 allows the IRS to reduce or remove interest attributable to errors or delays made by the IRS in the performance of ministerial acts.

2. Partially agree with the notice. The taxpayers wish to have the IRS reduce any taxes attributed to the incorrect changes made by the IRS. Taxpayers will substantiate the correct entries and ask the IRS to recompute taxes, penalties and interest.

***PRACTICE POINTER*:** Regardless of the position the taxpayers take, the attorney should always review the entire return. Often there are other errors on the return. In many cases the taxpayers have made preparation errors which would reduce their taxes requested in the IRS notice. Corrections of these preparation errors may offset the additional tax requested in the IRS notice. A Form 1040X will be required to amend the return. The taxpayers will answer the IRS notice, explain the amended return and attach a copy. The original amended return will post separately and will include any taxes due.

3. Wholly disagree with the notice. Taxpayers will substantiate the entries and computations on the return and ask the IRS to confirm the original taxes due or refund requested.

B. Regardless of the position the taxpayers take on the notice, the reply to any notice should clearly state the name and address of the taxpayers, the tax year in question, the tax form originally filed, the notice to which the reply pertains, and any client authorization involved. Enclose the reply in the bar coded envelope provided by the IRS. The IRS Service Center must hand sort other envelopes and this will increase the processing time, at best. At worst the plain envelope will be routed to an incorrect office.

VII. CONCLUSION.

CHAPTER B

RULES OF PROFESSIONAL RESPONSIBILITY APPLICABLE TO THE TAX PRACTITIONER

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RULES OF PROFESSIONAL RESPONSIBILITY APPLICABLE TO THE TAX PRACTITIONER

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. Primary.

1. Treasury Department Circular Number 230, Regulations Governing the Practice before the Internal Revenue Service. (June 12, 2014) (31 C.F.R. Part 10).

2. The Internal Revenue Code of 1986.

3. Army Regulation 27-26, The Rules of Professional Conduct for Lawyers (1 May 1992).

4. Air Force Rules of Professional Conduct and Standards for Civility in Professional Conduct, TJAG Policy Letter TJS-2, 17 August 2005; Air Force Standards for Criminal Justice, TJAG Policy Letter TJS-3, 15 May 2005; TJAGC Professional Responsibility Program, TJAG Policy Letter TJS-5, 17 Aug 05.

5. Professional Conduct of Attorneys Practicing Under the Cognizance and Supervision of The Judge Advocate General, JAG Inst 5803.1D (1 May 2012).

6. American Bar Association Model Rules of Professional Conduct (2009).

7. American Bar Association Model Code of Professional Responsibility (1983).

B. Secondary.

1. The Legislative History of the Model Rules of Professional Conduct, ABA (1987).

2. The Model Rules of Professional Conduct Annotated, ABA (1986).

II. COMPETENCE.

A. Competence requires legal knowledge, skill, thoroughness, and preparation to the extent reasonably necessary for representation (Army Rule 1.1).

B. A lawyer need not have special training or experience to handle a matter.

C. Supervisor's Role.

1. Training.

2. Oversight.

3. Standard Procedures.

D. Competence in Tax Preparation. Must balance powerful automation tools, increasingly sophisticated areas of practice, and tremendous mission demands.

III. CONFIDENTIALITY (ARMY RULE 1.6).

A. General Rule. A lawyer shall not reveal any information relating to the representation of a client.

1. No distinction between confidences and secrets as existed in the older ABA Model Code.

2. Applies to information obtained prior to formation of attorney-client relationship.

B. Purpose. Encourage candor between the client and the attorney.

C. Exceptions to confidentiality.

1. A client may consent to disclosure of confidential information.

2. Disclosure is also authorized in order to carry out the representation.

a. Office communications.

b. Reading files.

3. Disclosure is permitted to establish a claim or defense in a controversy with a client.

4. Intention to commit a crime.

a. Army/Navy Rule 1.6(b) <u>mandates</u> disclosure of information a lawyer reasonably believes necessary to prevent a client from committing a crime which is likely to:

(1) result in imminent death or substantial bodily harm, or

(2) significantly impair the readiness or capability of a military unit, vessel, aircraft, or weapon system.

b. Air Force Rule 1.6(b) gives attorneys discretion to reveal information regarding crimes falling within the two categories.

c. ABA Model Rules only give attorneys discretion to reveal information regarding crimes that result in imminent death or substantial bodily harm.

d. There is no authority for revealing information of other future offenses under the Army Rules.

e. Information regarding past crimes may not be released under any of the ethical standards.

D. Work Product Rule. The work product rule is subsumed within the rule of confidentiality.

1. Materials prepared by an attorney in anticipation of litigation are not discoverable.

2. The work-product privilege is intended to prevent a litigant from taking a free ride on the research and thinking of his opponent's lawyer and to avoid the resulting deterrent to a lawyer's committing his thoughts to paper. United States v. Nobles, 422 U.S. 225, 236-39 (1975); Hickman v. Taylor, 329 U.S. 495, 510-11; *id*. at 516 (Jackson, J., concurring).

E. Federally Authorized Tax Practitioner Privilege. I.R.C. § 7525.

1. The attorney-client privilege allowed for confidential communications regarding the provision of tax advice has been extended to all federally authorized tax practitioners (that is, to individuals authorized to practice before the IRS).

2. The provision does not modify the attorney-client privilege of confidentiality, other than to extend it to other authorized practitioners. Sen. Rep. 105-174, "Internal Revenue Service Restructuring and Reform Act of 1998," at 70.

a. The privilege established by the provision applies only to the extent that communications would be privileged if they were between a taxpayer and an attorney. Sen. Rep. 105-174, "Internal Revenue Service Restructuring and Reform Act of 1998," at 70.

b. Information disclosed to an attorney for the purpose of preparing a tax return is not privileged under present law. Such information would not be privileged under the provision whether it was disclosed to an attorney, certified public accountant, enrolled agent or enrolled actuary. Sen. Rep. 105-174, "Internal Revenue Service Restructuring and Reform Act of 1998," at 70.

c. Nothing in the new statute suggests that nonlawyer practitioners are entitled to privilege when they are doing other than lawyers' work. United States v. Frederick, 182 F.3d 496 (7th Cir. 1999).

(1) There is no common law accountant's or tax preparer's privilege. Couch v. United States, 409 U.S. 322, 502 (1973); United States v. Arthur Young & Co., 465 U.S. 805, 817-19 (1984).

(2) A taxpayer must not be allowed, by hiring a lawyer to do the work that an accountant, or other tax preparer, or the taxpayer himself or herself, normally would do, to obtain greater protection from government investigators than a taxpayer who did not use a lawyer as his tax preparer would be entitled to. United States v. Lawless, 709 F.2d 485, 487-88 (7th Cir. 1983); United States v. Bornstein, 977 F.2d 112, 116-17 (4th Cir. 1992); In re Grand Jury Investigation, 842 F.2d 1223, 1224-25 (11th Cir. 1987); United States v. Davis, 636 F.2d 1028, 1043 (5th Cir. 1981).

(3) To rule otherwise would be to impede tax investigations, reward lawyers for doing nonlawyers' work, and create a privileged position for lawyers in competition with other tax preparers--and to do all this without promoting the legitimate aims of the attorney-client and work-product privileges. United States v. Frederick, 182 F.3d 496, 500 (7th Cir. 1999).

3. The privilege applies to any noncriminal tax proceeding before the IRS or in federal court.

4. The privilege does not protect work product.

F. The attorney-client privilege extends only to legal advice given by a lawyer. Although preparation of tax returns by itself may require some knowledge of the law, it is primarily an accounting service.

1. Communications relating to that service should therefore not be privileged, even though performed by a lawyer. United States v. Davis, 636 F.2d 1028, 1043 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981).

2. Preexisting documents transferred to an attorney are generally protected by the attorney-client privilege only if the usual common-law prerequisites for the privilege are satisfied: the information in the documents must be confidential and the transfer must have been made to obtain legal advice. United States v. Davis, 636 F.2d 1028,1040 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981).

   a. If the client transmitted the information so that it might be used on the tax return, such a transmission destroys any expectation of confidentiality. United States v. Lawless, 709 F.2d 485, 488 (7th Cir. 1983)

   b. Letters from the client to the attorney seeking legal advice and all documents created by the attorney that are within the normal ambit of the common-law attorney-client privilege remain privileged. United States v. Davis, 636 F.2d 1028,1040 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981).

G. The giving of tax advice and the preparation of tax returns are matters within the professional competence of an attorney and are prima facie subject to the attorney-client privilege. Colton v. United States, 306 F.2d 633, 637-38 (2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963).

1. Although the word "communications" must be broadly interpreted in this context, the authorities are clear that the privilege extends essentially only to the substance of matters communicated to an attorney in professional confidence. Colton v. United States, 306 F.2d 633, 637-38 (2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963).

2. Not all communications between an attorney and his client are privileged. Particularly in the case of an attorney preparing a tax return, a good deal of information transmitted to an attorney by a client is not intended to be confidential, but rather is given for transmittal by the attorney to others -- for example, for inclusion in the tax return. Such information is, of course, not privileged. Colton v. United States, 306 F.2d 633, 637-38 (2d Cir. 1962), *cert. denied*, 371 U.S. 951 (1963).

H. Work Product and Tax Preparation.

1. Workpapers created to aid in preparing tax returns that are not primarily to help litigate over those returns are outside the scope of the work product doctrine. United States v. Davis, 636 F.2d 1028, 1040 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981).

2. Papers generated by an attorney who prepares a tax return are not within the work product privilege simply because there is always a possibility that the IRS might challenge a given return. *See* Colton v. United States, 306 F.2d 633, 639-40 (2d Cir. 1962), *cert. denied* 371 U.S. 951 (1963).

IV. CONFLICT OF INTEREST RULES.

A. Representation adverse to existing or former clients.

1. Army Rule 1.7(a) prohibits a lawyer from representing a client if the representation of the client will be adverse to another (present) client unless:

   a. the lawyer reasonably believes the representation will not adversely affect the other relationship, **and**

   b. the client consents.

2. Army Rule 1.9 prohibits a lawyer, who has formerly represented a client in a matter:

   a. from representing another person in the same or substantially related matter unless the client consents after consultation, or

   b. from using information to the disadvantage of the former client.

3. Circular 230, section 10.29 -- Conflicting interests. A practitioner shall not represent a client in his or her practice before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if:

a. The representation of one client will be directly adverse to another client; or

b. There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person or by a personal interest of the practitioner.

c. Notwithstanding a. and b., above, a practitioner may represent a client if:

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law;

(3) Each affected client gives informed consent, confirmed in writing by the affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period after the informed consent, but in no event later than 30 days. Copies of the written consents must be retained by the practitioner for 36 months from the conclusion of the representation.

B. Dual Representation in Tax Preparation.

1. The preparation of a joint return should not normally give rise to a conflict of interest.

2. Preparation of married filing separate returns almost always has the potential for a conflict of interest.

3. Representing both parties when their joint return is being audited has the potential for a conflict of interest.

4. Circular 230 appears to permit the waiver of any conflict, but Army Rule 1.7(a) imposes a higher standard.

C. Dual Representation in Estate Planning.

1. Client confidences - Husband and wife request estate counseling together.

a. Must consent to a joint interview.

b. Recommended - sign consent memorandum for case file. (See Appendix A).

2. Conflicts of Interest.

a. Spouse with children of former relationship.

b. Child of testator present for interview.

V. YOUR CLIENT AND THE IRS.

A. IRS Nondisclosure Rule.

1. Any person who discloses without proper authorization any return or return information is subject to criminal penalties (I.R.C. § 7213).

a. If any employee of the United States knowingly and without authority discloses any return or return information with respect to a taxpayer, such affected taxpayer may bring a civil suit against that employee (I.R.C. § 7431).

VI. THE TAX PREPARER AND THE IRS.

A. Practicing before the IRS -- Circular 230, § 10.2(a)(4). Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings.

1. Any individual may prepare a return, appear as a witness for the taxpayer before the IRS, or furnish information requested by the IRS. Circular 230, § 10.8(b).

2. The following individuals have broad authority to practice before the IRS:

   a. Attorneys;

   b. Certified Public Accountants; and

   c. Enrolled agents.

3. The following individuals have limited authority to practice before the IRS:

   a. Enrolled actuaries;

   b. Enrolled retirement plan agents;

   c. Registered tax return preparer;

   d. Full time employees of an employer may represent the employer;

e. A general partner or a regular full-time employee of a partnership may represent the partnership;

f. A trustee, receiver, guardian, administrator, or personal representative, may represent the trust, receivership, guardianship, or estate.

g. An individual may represent any individual before personnel of the Internal Revenue Service who are outside of the United States;

h. An individual who prepares and signs a taxpayer's return, or who prepares a return but is not required to sign the return, may represent the taxpayer before officers and employees of the examination division of the IRS with respect to the tax liability of the taxpayer for that tax year;

i. The Director of the Office of Professional Responsibility may authorize others who are not otherwise eligible to practice before the IRS.

B. Representing Your Client.

1. Form 2848 - Power of Attorney and Declaration of Representation.

a. To represent the client before the IRS;

b. To receive confidential tax information pertaining to the client;

c. Receive, but not endorse a refund check;

d. Execute a waiver of restrictions on assessment or collection of a deficiency in tax;

e. Execute a consent to extend the statutory period; and

f. Execute a closing agreement under I.R.C. § 7121.

C. Practice before the IRS is governed by Treasury Circular No. 230.

1. Each attorney, CPA, enrolled agent, or enrolled actuary who knows that the client has not complied with the revenue laws of the United States or has made an error or omission … must advise the client promptly of the fact of such noncompliance, error, or omission and of the consequences of such noncompliance, error, or omission. Circular 230, § 10.21.

2. A taxpayer is generally not required to file an amended return.

   a. Treas. Reg. § 1.451-1(a) provides that a taxpayer "should" (not shall or must) file an amended return when he discovers that an item of income was omitted from an earlier, open, tax year.

   b. Treas. Reg. § 1.461-1(a)(3) provides that when a taxpayer discovers that a deduction should have been taken in a prior taxable year, the taxpayer should file an amended return to receive the credit or refund. Similarly, if a taxpayer discovers that a deduction was improperly taken into account in a prior taxable year, the taxpayer should file an amended return and pay any additional tax due.

   c. These regulations do not require a taxpayer to file an amended return. United States v. Badaracco, 464 U.S. 386 (1984).

   d. The practitioner should advise the client, as appropriate, that filing an amended return will reduce or eliminate a penalty, minimize interest on a deficiency, or provide some other advantage to the client.

3. Each attorney, CPA, enrolled agent, or enrolled actuary shall exercise due diligence as to accuracy:

   a. In preparing or assisting in the preparation of, approving, and filing returns.

   b. In determining the correctness of oral or written representations made by him to the IRS; and

c. In determining the correctness of oral or written representations made by him to clients with reference to any matter administered by the IRS. Circular 230, § 10.22.

4. No attorney, CPA, enrolled agent, or enrolled actuary shall unreasonably delay the prompt disposition of any matter before the IRS.

5. No attorney shall in practice before the IRS, knowingly and directly or indirectly employ or accept assistance from any person who is under disbarment or suspension from practice before the IRS.

D. Representing your Client before the IRS--The Duty of Confidentiality.

1. Circular 230 does not address this duty, but does acknowledge that certain client information may be "privileged," and that the practitioner may refuse to submit records if he "believes in good faith and on reasonable grounds that such [material] is privileged or that the request ... is of doubtful legality."

2. ABA Formal Opinion 314, which deals with the lawyer's obligations to make disclosures to the IRS, provides, that in dealing with the IRS, a lawyer:

a. Has no duty to disclose weaknesses in the case and may properly advance the strong points.

b. May not disclose client confidences unless it appears that a crime will be committed (a wrong or unjust result in a tax case is not a crime).

c. Has the affirmative duty not to mislead the IRS by misstatements or by silence, and not to permit the client to do so.

d. To advise the client to correct misstatements.

(1) If client refuses to do so, the lawyer is obligated to withdraw from the representation.

(2) The duty to withdraw may be limited, and must be weighed against the lawyer's obligation of confidentiality.

e. Disreputable conduct for which an attorney, certified public accountant, enrolled agent, or enrolled actuary may be disbarred or suspended from practice before the Internal Revenue Service includes, but is not limited to: "Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement, written or oral, are included in the term "information." Circular 230, § 10.51(a)(4).

E. Standards for Advising Client with Respect to Tax Return.

1. Definitions.

a. Frivolous - a position is frivolous if it is patently improper.

b. Reasonable basis - A position is considered to have a reasonable basis if it is reasonably based on one or more of the authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations. Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(1) The authorities described in Treas. Reg. § 1.6662-4(d)(3)(iii) successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a position will not be challenged by the Service (e.g., because the taxpayer's return may not be audited or because the issue may not be raised on audit) may not be taken into account.

(2) Types of Authority -- Treas Reg. § 1.6662-4(d)(3)(iii).

(a) Applicable provisions of the Internal Revenue Code and other statutory provisions;

(b) Proposed, temporary and final regulations;

(c) Revenue rulings and revenue procedures;

(d) Tax treaties;

(e) Court cases;

(f) Legislative histories;

(g) Private letter rulings and technical advice memoranda issued after October 31, 1976;

(h) Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general; and counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); and

(i) Internal Revenue Service information or press releases; and notices and announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

(3) Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority.

c. More likely than not - A practitioner is considered to have a reasonable belief that the tax treatment of a position is more likely than not the proper tax treatment if the practitioner analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment will be upheld if the IRS challenges it. The authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis.

2. Standards of Conduct. Circular 230, § 10.34.

a. A practitioner may not sign a tax return as a preparer unless the practitioner has a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on its merits (the more likely than not standard), or there is a reasonable basis for each position and each position is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless--

(1) The practitioner has a reasonable belief that the position satisfies the more likely than not standard; or

(2) The position has a reasonable basis and is adequately disclosed to the Internal Revenue Service.

b. A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

c. A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service—

(1) The purpose of which is to delay or impede the administration of the Federal tax laws;

(2) That is frivolous; or

(3) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

d. Advising clients on potential penalties. A practitioner must inform the client of the penalties reasonably likely to apply to the client with respect to a position taken on a tax return, if the practitioner advised the client with respect to the position or prepared or signed the tax return, or to any document, affidavit or other paper submitted to the Internal Revenue Service. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This rule applies even if the practitioner is not subject to a penalty with respect to the position.

e. Relying on information furnished by clients. A practitioner advising a client to take a position on a return or other paper submitted to the Internal Revenue Service, or preparing or signing a return as a preparer, generally may rely in good faith without verification upon information furnished by the client. However, the practitioner may not ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

f. Standard of discipline. Only violations of this section that are willful, reckless, or a result of gross incompetence will subject a practitioner to censure, suspension or disbarment from practice before the Service.

F. Penalties applicable to Income Tax Preparers.

1. Understatements of taxpayer's tax liability (I.R.C. § 6694).

a. Understatements due to a position taken for which there was no reasonable belief that the tax treatment of the position would more likely than not be sustained on its merits.

(1) Penalty is the greater of $1,000 or 50% of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty was imposed.

(2) Exception for position that had a reasonable basis and was adequately disclosed on the return.

(3) Exception for position advanced in good faith and with reasonable cause. Factors to consider in determining reasonable cause include:

(a) Nature of the error causing the understatement. Whether the error resulted from a provision that was so complex, uncommon, or highly technical that a competent preparer of returns or claims of the type at issue reasonably could have made the error.

(b) Frequency of errors. Whether the understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors.

(c) Materiality of errors. Whether the understatement was material in relation to the correct tax liability.

(d) Preparer's normal office practice. Whether the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim in question.

(e) Reliance on advice of another preparer. Whether the preparer relied in good faith on the advice of or schedules prepared by another preparer.

b. Willful attempt to understate tax liability or reckless or intentional disregard of rules or regulations results in a preparer penalty of the greater of $5,000 or 50% of the income derived (or to be derived) by the tax return preparer.

(1) Willful attempt to understate liability. A preparer is considered to have willfully attempted to understate liability if the preparer disregards, in an attempt wrongfully to reduce the tax liability of the taxpayer, information furnished by the taxpayer or other persons. For example, if a preparer disregards information concerning certain items of taxable income furnished by the taxpayer or other persons, the preparer is subject to the penalty. Similarly, if a taxpayer states to a preparer that the taxpayer has only two dependents, and the preparer reports six dependents on the return, the preparer is subject to the penalty.

(2) Reckless or intentional disregard. A preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question.

(a) A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.

(b) A preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation is not frivolous, is adequately disclosed and, in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.

2. IRS Agents may notify the Director of the Office of Professional Responsibility of any tax practitioner who is assessed with a penalty.

3. Other Penalties applicable to income tax preparers -- I.R.C. § 6695.

   a. Penalty is $50 for each offense up to a maximum of $25,000 for the following:

      (1) Failure to furnish copy of return to TP.

      (2) Failure to sign return.

      (3) Failure to furnish ID number.

      (4) Failure to retain a copy or list.

      (5) Failure to file correct information returns.

   b. Negotiation of a taxpayer's check is a $500 penalty.

   c. Failure to be diligent in determining eligibility for the earned income credit is a $500 penalty.

4. Tax return preparer defined. The term "tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by the Internal Revenue Code or any claim for refund of tax imposed by the Internal Revenue Code. I.R.C. § 7701(a)(36). IAW Treas. Reg. § 301.7701-15(a)(7) the following persons are not tax return preparers:

   a. Any individual who provides tax assistance under a Volunteer Income Tax Assistance (VITA) program established by the Internal Revenue Service; and

   b. Any organization sponsoring or administering a Volunteer Income Tax Assistance (VITA) program established by the Internal Revenue Service, but only with respect to that sponsorship or administration.

G. Client Penalties.

1. Delinquency Penalties (I.R.C. § 6651).

a. Failure to file timely return.

b. Failure to pay tax.

2. Accuracy related penalties (I.R.C. §§ 6662 and 6663).

a. Only apply if a return is filed.

b. Negligence Penalty (20%). Applies when the taxpayer fails to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or disregards the rules and regulations.

(1) Examples of negligence include, failure to include all income, excessive deductions, improper credits, failure to maintain adequate books and records, withholding information from return preparer.

(2) Defense to Negligence Penalty.

(a) Reasonable basis. Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in Sec. 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard. Treas. Reg. § 1.6662-3(b)(3).

(b) If position contrary to the rules and regulations, can avoid penalty by disclosure if position represents a good faith challenge and the challenge has a reasonable basis (Form 8275R).

(c) Can also avoid penalty if reasonable basis for position and adequate disclosure (Form 8275).

c. The accuracy related penalty also applies to a substantial understatement of income tax (20% penalty).

(1) Where the understatement exceeds the greater of:

(a) 10% of the amount of tax required to be shown on the return; or

(b) $5,000.

(2) Amount of the penalty is reduced by the amount relating to an item for which there was:

(a) substantial authority; or

(b) reasonable basis and adequate disclosure.

(3) The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the "more likely than not" standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard (the standard which, if satisfied, generally will prevent imposition of the penalty under section 6662(b)(1) for negligence). Treas. Reg. § 1.6662-4(d)(2).

(a) There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(i).

(b) The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. Treas. Reg. § 1.6662-4(d)(3)(i).

(c) The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied. Treas. Reg. § 1.6662-4(d)(2).

d. Accuracy related penalties cannot be stacked.

3. Fraud (I.R.C. § 6663).

a. A willful attempt to evade taxes.

b. Fraud is an act of commission, not omission.

c. Examples of what the government must show by clear and convincing evidence:

(1) Double set of books;

(2) Making false entries or alterations;

(3) False invoices or documents;

(4) Concealed assets; and

(5) False statements to agents.

d. Penalty for fraud is 75%.

4. Reasonable cause exception -- I.R.C. § 6664(c). Even if the taxpayer cannot satisfy the reasonable basis exception, no penalty shall be imposed under section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

   a. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.

   b. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability.

   c. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer.

   d. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith.

   e. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect.

      (1) Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

      (2) All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law.

5. Frivolous income tax return -- I.R.C. § 6702. Any individual who files what purports to be an income tax return but which -

a. Does not contain information on which the substantial correctness of the self-assessment may be judged, or

b. Contains information that on its face indicates that the self-assessment is substantially incorrect; and the conduct is due to:

(1) As position which is frivolous, or

(2) A desire (which appears on the purported return) to delay or impede the administration of Federal income tax laws, then such individual shall pay a penalty of $5,000.

c. This penalty shall be in addition to any other penalty provided by law.

H. Criminal Penalties (Title 18).

1. Willful attempt to evade or defeat tax (Maximum penalty is five years and $100,000 fine).

2. Willful failure to file return (Maximum penalty is one year in prison and a fine of $25,000 fine).

3. Willful fraud and false statements (Maximum penalty is three years and a fine of $100,000 fine).

I. Disbarment from Practice before the IRS.

1. Disbarment or suspension from practice as an attorney.

2. Conviction of any criminal offense involving the revenue laws or any crime involving dishonesty, or breach of trust.

3. Giving false or misleading information, or participating in any way in the giving of false or misleading information to the IRS .

4. Improper solicitation of employment.

5. Willfully failing to make a Federal tax return in violation of the revenue laws.

6. Bribing or attempting to bribe any officer or employee of the IRS.

7. Misappropriation of, or failure to properly and promptly remit funds received from a client for the purpose of payment of taxes or other obligations due the United States.

8. Knowingly aiding and abetting another person to practice before the IRS during a period of suspension, disbarment, or ineligibility.

9. Contemptuous conduct in connection with practice before the IRS.

10. Giving a false opinion, knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation that is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

11. Willfully violating any part of Circular 230. Recklessly or through gross incompetence violating the section of Circular 230 pertaining to standards for preparing returns and advising clients.

VII. CONCLUSION.

APPENDIX

SAMPLE DUAL REPRESENTATION LETTER

Dear _____:

This letter confirms the following:

1. You have requested that I represent each of you and advise you on certain estate planning matters.

2. It is contemplated that the matters to which my representation will extend will include the following: (Choose from the following or modify as appropriate.

a. Analysis of your wills, codicils, trusts, and property agreements, if any.

b. Analysis of the assets owned by each of you, including consideration of their value and the nature in which title is or should be held, and the categorization of such assets as separate or community property.

c. Discussions about the manner in which you wish to dispose of such property.

d. Analysis of the tax impact of such disposition and recommendations relative thereto.

3. I have advised each of you that, during the course of the estate planning work, that conflicts may arise between you with respect to the ownership of your property and its desired disposition. Differences of opinion on the disposition of the property, under ethical rules, do not prevent me from continuing to represent both of you. However, during the course of the estate planning, conflicts of interest between you may arise, such as issues regarding the ownership of certain property.

Ordinarily, under such circumstances, one attorney cannot represent both of you. It may be better for each of you, under such circumstances, to have separate independent counsel to avoid the possibility that my advice to one of you is influenced by my representation of the other. Nevertheless, you have requested, with full understanding of your right to, and the advantages of, independent counsel, that I represent both of you in all of the above matters.

4. Although I doubt that will happen, if conflicts do arise between the two of you of such a nature that I believe it impossible for me to perform my obligations to either of you, I will withdraw from all further representation of both of you in this matter at that time and advise one or both of you to obtain independent counsel.

5. You have agreed that there will be complete and free disclosure and exchange of all information that I receive from either or both of you in the course of my representation of you and that such information shall not be confidential between you irrespective of whether I obtain such information in conferences with both of you or in private conferences with only one of you, including any conferences that may have taken place before the date of this letter.

Sincerely,

(Attorney's Signature Block)

Dated: _____, 20____ I have read the foregoing letter, understand the same, consent to the disclosure and exchange of all information received by you from either one of us, with the other one of us, and consent to representing each and both of us in the aforementioned estate planning services.

_____ _____

(Signature of husband; typed name below) (Signature of wife; typed name below)

CHAPTER C

CASUALTY TAX ISSUES

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. IRS Forms: Form 1040, 1040A, 1040 EZ, 1310.

B. Internal Revenue Code (I.R.C.) of 1986, as amended.

C. Treasury Regulations.

D. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.
2. Pub. 17, Your Federal Income Tax.
3. Pub. 559, Survivors, Executors, and Administrators.

II. INTRODUCTION.

III. FILING REQUIREMENT.

A. A final tax return is required to be filed.

1. File a return for the year of death.

2. File a return for any other preceding years not yet filed.

3. Example: SFC Samantha Smith died on March 14, 2014 before filing her 2013 return. Her 2013 return is still due 15 April 2014 and her final return is due 15 April 2015 for the 2014 tax year.

B. Who files the returns?

1. The personal representative, if one is appointed.

2. Surviving spouse can file if filing a joint return and no personal representative appointed before the due date for the return.

3. May need to complete Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, if not the surviving spouse or a court appointed personal representative. (Court appointed PR must attach the court certificate, for example, Letters Testamentary).

IV. FILING STATUS.

1. The filing status choices are the same as if the decedent were alive for the relevant year.

2. A surviving spouse can file a joint return with the decedent for the final tax return as long as he or she has not remarried before the end of the year of the decedent's death. In the case of the surviving spouse remarrying, the decedent's filing status for the final return is MFS.

3. A surviving spouse, who remains unmarried, can use qualifying widow(er) filing status for up to 2 years after the year of death if they have a dependent child. This filing status entitles the survivor to MFJ tax rates and higher standard deduction if they cannot itemize.

V. OTHER CONCERNS.

A. Exemptions and Deductions. Generally, the rules that apply to an individual apply the same to the decedent's final return.

1. You can claim the decedent's personal exemption on the final return (assuming they were not the dependent of someone else, like a parent).

2. The final return can claim the filing status' standard deduction or can itemize deductions claiming deductions paid by the decedent prior to death.

B. Credits, Other Taxes, and Payments. Generally, the rules that apply to an individual apply the same to the decedent's final return.

1. The decedent's final return can claim the Earned Income Tax Credit, if applicable, even though the return covers less than 12 months.

2. The decedent's final return can claim the Child Tax Credit, and the Additional Child Tax Credit, if applicable, even though the return covers less than 12 months.

3. The adoption credit can be claimed on the decedent's final return, depending on when the adoption was finalized, including any carryforward credit from prior years. Also, if the decedent is survived by a spouse who meets the filing status of qualifying widow(er), any unused adoption credit may be carried forward and used by the qualifying widow(er) following the death of the decedent.

4. Claim all federal income tax withheld and any estimated taxes on the final return.

C. Finishing the Return.

1. The word "DECEASED", the name of the decedent, and the date of death should be written across the top of the return.

2. If the decedent is a Servicemember who died in a combat zone, then at the top of the return put "KIA" and the combat zone where the death occurred or the injury/disease leading to the death occurred instead of "Deceased".

3. If surviving spouse is filing a joint return, use both names in the name and address section.

4. If a personal representative is filing the return, put the decedent's name in the name space and then personal representative's name and address in the other space.

D. Signing the return.

1. If the surviving spouse is filing a joint return, the spouse signs as usual. But in the space for the deceased spouse's signature, write "Filing as Surviving Spouse."

2. If a personal representative is filing the return, then the personal representative signs the return, and if that personal representative is not the surviving spouse and it is a joint return, the surviving spouse must also sign the return.

E. Filing the Return.

1. File the return with the Internal Revenue Service Center for the place where the surviving spouse or personal representative lives.

2. For Servicemembers killed in a combat zone, file the return with the Internal Revenue Service, 333 W. Pershing, P5-6503, Kansas City, MO 64108.

3. For Servicemembers killed in the combat zone, attach proof of the death in the combat zone. The DD Form 1300 (Report of Casualty) will suffice, or a letter from the Casualty Office certifying that the Servicemember was on active duty and died in a combat zone.

VI. TAX FORGIVENESS FOR COMBAT DEATHS.

A. Members of the Armed Forces who die while in a combat zone or from wounds, disease, or injury incurred in a combat zone, have their tax liability abated (forgiven) for the entire year of death and for any prior tax year ending on or after the first day the member served in a combat zone. IRC § 692(a).

1. Members of the Armed Forces: defined in IRC § 7701(a)(15) to include all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and also includes the Coast Guard.

2. A combat zone is any area that the President, by executive order, designates as an area in which Armed Forces of the United States are or have engaged in combat. IRC § 112. Qualified hazardous duty areas are treated as combat zones during the periods that members of the Armed Forces are entitled to special pay for duty in a hostile area under 37 USC § 310.

3. This section applies to all tax liability resulting from income of the deceased Servicemember, not just military compensation.

B. Joint Returns and Forgiveness.

1. Only the Servicemember's tax liability is abated, not the spouse's tax liability. Note: this is an abatement of the tax liability, not an exclusion of the income.

2. Must allocate tax liability between the Servicemember and spouse pursuant to a formula for years where a spouse has income and the abatement is claimed for the decedent under IRC section 692.

a. Calculate the tax liability of the couple on a joint return as if no forgiveness were allowed;

b. Calculate the tax liability of the decedent as if he or she filed married filing separately;

c. Calculate the tax liability of the surviving spouse as if he or she filed married filing separately;

d. Add together the tax liabilities of the decedent and the spouse as married filing separately;

e. Calculate a percentage equal to decedent's married filing separately tax liability (as determined in subparagraph b above) divided by the total of the joint tax liability (as determined in subparagraph d above);

f. Multiply that decimal by tax liability of a MFJ, this is the amount of the tax liability forgiven on the joint return.

3. Example: Assume MFJ tax liability is $6,000. W is killed in Afghanistan while serving on active duty. MFS returns for W and H result in W's tax liability being $3,200 and H's tax liability being $4,800. W's separate liability would be 40% [3,200/8,000 = .40]. Therefore $2,400 of the $6,000 MFJ tax liability is abated [6,000 x .40 = 2,400] and $3,600 is owed.

C. Prior Years. IRC Section 692(a) abates tax liability for any tax year ending on or after the first day the person served in **a** combat zone.

1. Because it says "**a** combat zone" rather than "**the** combat zone" if a Servicemember served in more than one combat zone or in the same combat zone in different tax years, a tax on the Servicemember's income will not be imposed for years preceding the death, beginning with the tax year that the individual first served in any combat zone. See Revenue Ruling 69-301, 69-1 C.B. 183.

2. However, Rev. Ruling 69-301 also makes clear that tax abatement claims under section 692(a) are claims for refund which are subject to the statute of limitation provisions for refunds under section 6511(a), as suspended by Section 7508(a)(1)(E) if applicable.

D. Determining the Statute of Limitations.

1. IRC Section 6511(a) provides that claims for refund must be filed within 3 years from the date the return was filed or two years from the date the tax was paid, whichever is later.

a. Generally, that means that a taxpayer has 3 years from the due date (15 April) to file a request for refund. If 15 April for any year falls on a holiday or weekend then the due date is the next working day.

b. IRC Section 6513 provides that if you file your return before the original due date (without regard to extensions) then you are deemed to have filed it on the due date. Thus, if you file your 2013 tax return on 1 February 2014, for statute of limitation purposes you have until 15 April 2017 (3 years from 15 April 2014) to file for refund for 2013.

2. IRC Section 7508(a)(1)(E) provides Servicemembers serving in a combat zone an automatic extension to file a claim for refund for the period that the Servicemember is in the combat zone, and for the next 180 days thereafter.

3. IRC Sections 692, 6511 and 7508 all apply to prior year claims for refunds so Servicemember's surviving spouses or personal representatives should file amended returns for all years that are still open and not subject to the statute of limitations.

4. Examples:

   a. Servicemember served in Afghanistan from 1 July through 31 October 2011. He served in Iraq from 1 January 2012 through March 23, 2012 (date of death). IRC § 692(a) provides abatement of tax for both tax year 2011 and tax year 2012.

   b. Assume the same facts above but also assume that Servicemember served in various combat zones between 1997 – 2012. All those returns are eligible for tax abatement. However, this would be subject to IRC §§ 7508 and 6511 so you have to compute for each year the CZ extensions and due dates and see if you can still file an amended return.

VII. SURVIVOR ISSUES.

A. Survivor Benefit Plan (SBP).

1. SBP coverage is automatic for all active duty members who have an eligible beneficiary. However, if the Servicemember is not yet retirement eligible, the Servicemember's death must have occurred in the Line-of-Duty in order for the SBP to be payable to the beneficiary. For an active duty death, SBP payments equal 55% of what the member's retired pay would have been had the member been retired at 100% disability.

2. SBP is offset, dollar for dollar, by Dependency Indemnity Compensation (DIC) paid by the Department of Veterans Affairs.

3. SBP is a taxable annuity payment. DIC is a non-taxable benefit.

4. The SBP can go to a surviving spouse or the spouse can elect (thru the military service) to choose child only SBP. In this case, the spouse would receive DIC and the child would receive SBP up until the age of 23 (longer if the child is mentally or physically disabled and unable to care for themselves).

5. If a child is receiving SBP it is still taxable and is taxable on the child's return.

   a. If the SBP and other unearned income for the child, in total, is more than $2,000, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. If the parent does not or cannot choose to include the child's income on the parent's return, use Form 8615 to figure the child's tax.

   b. A dependent has to file a return if he or she has more than $1,000 in SBP benefits and other unearned income for the year.

B. Social Security Survivor Benefits.

1. An unremarried surviving spouse may qualify for SS survivor benefits if they are over retirement age themselves or are caring for the decedent's child under the age of 16 (or is disabled).

   a. The amount of the SS survivor benefit depends on the age of the surviving spouse, their earnings, and their marital status.

   b. If a surviving spouse under his full retirement age earns more than $15,480, he will have the widow(er) benefit reduced. The amount of the reductions is $1 deducted for every $2 dollars earned above $15,480 (adjusted annually for inflation).

2. Decedent's unmarried child under the age of 18 (or any age if disabled before the age of 22) receives SS survivor benefits as well.

3. Social Security benefits may be taxable. Generally, SS benefits are not taxable if the individual's total income is under $25,000 if you are single, head of household, or qualifying widow(er). $32,000 if MFJ.

   a. Who is taxed? The person who has the legal right to receive the benefits.

   b. Thus a child receiving SS benefits may have taxable SS benefits if they are also receiving SBP and/or other income (interest, dividend, trust income etc.)

VIII. CONCLUSION.

CHAPTER D

STATE INCOME TAXATION, THE SCRA, AND THE MSSRA

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CAUTION: This document is meant only as an educational outline for training purposes and as a starting point for conducting tax research. Many of the IRS publications and forms were not finalized at the time of the drafting of this document. In addition, numerous potential changes in tax law are being debated and enacted all the time. Tax practitioners are highly encouraged to check the IRS website www.irs.gov for the latest publications reflecting the most recent tax legislation.

STATE INCOME TAXATION, THE SCRA, AND THE MSSRA

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. 50 U.S.C. App. §§501-596.

B. TJAGLCS Publication JA 260, Servicemembers' Civil Relief Act Guide, Ch. 5 (March 2006).

C. *Military Spouses Residency Relief Act State Tax Guide*, U.S. Navy OJAG, Code 16.

D. *Navy State Tax Guide*, U.S. Navy OJAG, Code 16.

II. INTRODUCTION.

A. THE AUTHORITY OF THE STATE TO TAX.

1. General - A state can tax all income, from whatever source derived, of domiciliaries and statutory residents.

2. With respect to nonresidents, states may tax all income earned within the state.

3. Definitions:

a) Domiciliary – "A person who resides in a particular place with the intention of making it a principal place of abode …" Black's Law Dictionary 559 (9th ed. rev. 2009).

b) BOTTOM LINE: Domicile or Legal Residence = Physical Presence and Intent to Permanently Reside in State. *See* Appendix A, *Fort Sheridan Tower* article, "Definition of 'Legal Residence'" 26 Feb. 1988.

(1) Indicia of domicile:

(a) Expressed intent, oral or written;

(b) **Physical presence, past and present** (including duration) [**Prerequisite to establishing domicile]**;

(c) Residence of immediate family. *See* U.S. v. Minnesota, 97 F. Supp. 2d 973 (D. Minn. 2000) (residence of non-military spouse not controlling factor or presumptive of military member domicile);

(d) Location of schools attended by children;

(e) Payment of nonresident tuition to institutions of higher education;

(f) **Payment of taxes (income and personal property)**. [Important factor] *But see* Wolff v. Baldwin, 9 N.J. Tax 11 (N.J. Tax Court 1986) (one cannot establish domicile by paying taxes alone; physical presence is also necessary);

(g) **Ownership of real property**. [Important

factor]; (h) Leasehold interests;

(i) Situs of personal property.

(j) **Voter registration**. [Important factor.] *See* Ca. Franchise Tax Board Legal Ruling No. 54, Residence: Effect of Military Personnel Registering to Vote, 1958 Cal. FTB LEXIS 54 (Cal. FTB 1958), and Captain Albert (vice) Gilbert Veldhuyzen and Commander Samuel F. Wright ARMY LAW article, "*Domicile of Military Personnel for Voting and Personnel*", Sept. 92 at 15.

(k) **Vehicle registration**. [Important factor] See Matter of Karsten, 924 P.2d 1272 (Ks. App. 1996) (Voluntary registration of motor vehicle doesn't equal automatic change of domicile);

(l) **Motor vehicle operator's permit**.[Important factor, but not controlling by itself-Va. Dep't of Taxation P.D. 99-132, 1999 Va. Tax LEXIS 131 (Va. Dep't of Tax. 7 June 1999)];

(m) Location of bank and investment accounts;

(n) Explanations for temporary changes in residence;

(o) Submission of DD Form 2058 (Change of Domicile Form-Appendix B);

(p) Home of record at the time of entering service;

(q) Place of marriage;

(r) Spouse's domicile. (see discussion below). *See* U.S. v. State of Minnesota, 97 F. Supp. 2d 973 (D. Minn. 2000) (state cannot rely on non-military spouses domicile to determine domicile of military member);

(s) Place of birth;

(t) Business interests;

(u) Sources of income;

(v) Outside employment;

(w) **Declarations of residence on legal documents such as wills, deeds, mortgages, leases, contracts, insurance policies, and hospital records.** [Important factor];

(x) **Declarations of domicile in affidavits or litigation.** [Important factor];

(y) Address provided on federal income tax return;

(z) Membership in church, civil, professional, service or fraternal organizations;

(aa) Ownership of burial plots;

(bb) Place of burial of immediate family members; and

(cc) Location of donees of charitable contributions.

(2) The History behind a Spouse's Domicile.

(a) Following arcane common law, some states mandate that a wife automatically assumes her husband's domicile, regardless of her intent.

(b) *See* ILL. ANN. STAT. ch. 23, para. 2-10 (West 1992) (the residence of a married woman shall be that of her husband unless they are living separate and apart, in which case she may acquire a separate residence).

(c) *See also* Restatement (Second) of Conflicts § 21 (1988) ("...there were at least two reasons for the common law rule.... (first) the very being or legal existence of the woman is suspended during marriage, or at least is incorporated and consolidated into that of the husband.... This view is no longer held. The second reason for the common law rule was the desirability of having the interests of each member of the family unit governed by the same law...").

(d) More states, however, are providing that a woman's domicile is established independently of her husband. These states include, among others, California, Colorado, Georgia, Minnesota, New Jersey, New York, North Dakota, Pennsylvania, Virginia, and Washington.

(e) *See* COMMENT TO VA. CODE ANN. § 20-91 (1992); Kerr v. Kerr, 371 So. 2d 30 (Va. Ct. App. 1988) (the outmoded expectation that a wife is expected to follow her husband's change of abode is no longer applicable).

(f) See U.S. v. State of Minnesota, 97 F. Supp. 2d 973 (D. Minn. 2000) (state cannot rely on non-military spouses domicile to determine domicile of military member, Minn. Stat. § 290.014 (2006)). See also, Carr v. Dep't of Revenue, 2005 Ore. Tax LEXIS 223, November 4, 2005.

c) Residence - implies something more than mere physical presence and something less than domicile; some states refer to "legal residence" as equivalent to "domicile".

(1) Personal presence at some place of abode with no present intention of definite and early removal and with purpose to remain for undetermined period, not infrequently, but not necessarily combined with design to stay permanently.

(2) Residence means the "place where one actually lives, as distinguished from a domicile… Residence usu. just means bodily presence as an inhabitant in a given place; domicile usu. requires bodily presence plus an intention to make the place one's home. A person thus may have more than one residence at a time but only one domicile." BLACK'S LAW DICTIONARY 1423 (9th ed. rev. 2009).

d) Statutory resident - a person receives tax treatment as if he or she was a domiciliary provided he or she resides in the state the statutory number of days.

(1) CAL. REV. & TAX. CODE § 17014(a) (West) ("Resident" includes: (1) Every individual who is in this state for other than a temporary or transitory purpose....") and § 17016 ("Every individual who spends in the aggregate more than nine months of the taxable year within this State shall be presumed to be a resident. The presumption may be overcome by satisfactory evidence that the individual is in the State for a temporary or transitory purpose." (Emphasis added)).

e) Nonresidents - are ordinarily defined in the negative: "One who does not live within the jurisdiction in question." BLACK'S LAW DICTIONARY 1157 (9th ed. rev. 2009).

4. Special State Military Treatment: Some states treat certain domiciliary military members as nonresidents for tax purposes. The tests for such status vary.

a) In some states, domiciliaries who are in the military service and are stationed outside the state are not required to pay state taxes while they are so stationed (e.g., Pennsylvania, Illinois).

b) Other states (e.g., New York, Missouri) employ a three-part test which permits domiciliaries to avoid state taxes if the domiciliary:

(1) Maintains no permanent place of abode in state of domicile;

(2) Maintains a permanent place of abode outside state of domicile; and

(3) Spends a maximum of 30 days within state of domicile during the tax year in question.

(4) *See, e.g.*, N.Y. Tax Law § 605 (McKinney) ("A resident individual means an individual: (1) who is domiciled in this state, unless he maintains no permanent place of abode in this state, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in this state."). [*See* Matter of Gatchell, 1984 N.Y. Tax Comm. 1984) (Servicemember who lives in a military barracks does not have a "permanent place of abode" and does not get the income tax exemption).]

5. Change of Legal Residence/Domicile.

a) Physical presence in the new state. *See* Juskowiak v. Commissioner of Revenue, 1996 Minn. Tax LEXIS 17 (Minn. 1996); Wolf v. Commissioner of Revenue, 1999 Minn. Tax LEXIS 41 (Minn. 1999), and Letter No. IT 96-0010, 1996 WL 305698 (Ill. Dept. Rev. 1996) (unpub.) (problems of JAG officer claiming change of legal residence from Wisconsin to Illinois), AND

b) Indications of simultaneous intent of making the new state the permanent domicile/legal residence. *See* Matter of Karsten, 924 P. 2d 1272 (Ks. App. 1996) (purchasing a house or registering a motor vehicle in a host jurisdiction does not automatically change a Servicemember's domicile, subjecting them to local taxation, unless the Servicemember indicates intent to change domicile.)

c) DD Form 2058 (Appendix B).

d) Carr v. Department of Revenue, 2005 WL 3047252 (Or. Tax Nov. 4, 2005). Servicemember purchased a home and registered vehicles in Oregon and asserted no intention of remaining in Oregon after military service. Servicemember asserted that Nevada was his state of domicile. State tax court concluded that Servicemember had no connections to Nevada since he owned no property in Nevada, was not registered to vote in Nevada, did not have a Nevada driver's license, and did not have any vehicles registered in Nevada. Servicemember could not just assert a domicile, must also have connections with that state.

III. PRINCIPLES OF THE SERVICEMEMBERS' CIVIL RELIEF ACT

A. U.S.C. app. § 571 provides that:

1. The Servicemember neither acquires nor loses residence or domicile solely by residing in a given state pursuant to military orders;

2. Military income is deemed to be earned in the state of domicile; and

3. A Servicemember's personal property is deemed to be located in state of domicile.

B. U.S.C. App. § 571 protects military income from double taxation because:

1. Military income is taxable only by the Servicemember's state of domicile; and

2. A Servicemember neither acquires nor loses domicile based on presence in a given state pursuant to military orders.

C. U.S.C. App. § 571 is constitutionally valid. Dameron v. Broadhead, 345 U.S. 322, 73 S. Ct. 721, 97 L.Ed. 1041 (1953).

D. A Servicemember's nonmilitary income is not protected from double taxation by § 571. Nonmilitary income can be taxed by:

1. The Servicemember's state of domicile, which can tax all income from whatever source derived; and

2. The state in which the income is earned (the legal fiction that a Servicemember's income is earned in the state of domicile applies only to military compensation).

E. Native American Military Member Exception. Fatt v. Utah State Tax Comm'n, 884 P.2d 1233 (Utah 1994); Turner v. Wis. Dep't of Revenue, 1986 WL 2536 (Wis. Tax App. Comm'n 1986) (unpub.)(Native American Servicemember's military income is deemed to be earned on his/her federal reservation domicile and thus is not subject to state income taxation).

IV. STATE TAXATION OF SERVICEMEMBER'S SPOUSE'S INCOME.

A. Military Spouses Residency Relief Act of 2009. Spouses who meet the domicile test (i.e., physical presence and the intent to make the state their permanent home) will receive protections similar to protections provided by the SCRA to Servicemembers. "A spouse of a servicemember shall neither lose nor acquire a residence or domicile for purposes of taxation with respect to the person, personal property, or income of the spouse by reason of being absent or present in any tax jurisdiction of the United States solely to be with the servicemember in compliance with the Servicemember's military orders if the residence or domicile, as the case may be, is the same for the servicemember and the spouse...Income for services performed by the spouse of a servicemember shall not be deemed to be income for services performed or from sources within a tax jurisdiction of the United States if the spouses is not a resident or domiciliary of the jurisdiction in which the income is earned because the spouse is in the jurisdiction solely to be with the servicemember serving in compliance with military orders." 50 App. U.S.C. § 571. (emphasis added).

1. Example 1: While stationed in Texas, a Servicemember who is a Texas domiciliary marries his civilian spouse who is also a Texas domiciliary. They buy real property, vote, get licensed, and register their vehicles in Texas. Later, the servicemember receives orders to move to Virginia. The Servicemember moves to Virginia and his spouse moves with him solely to be together. If the spouse works in Virginia, the spouse can assert the Military Spouses Residency Relief Act and Virginia cannot tax the spouse's income earned in Virginia.

2. Example 2: While stationed in Virginia, a servicemember who is a Texas domiciliary meets and marries his civilian spouse who lives and works in Virginia. The spouse cannot claim Texas as her domicile. Virginia will continue to tax the spouse's income because the Servicemember and the spouse do not share the same legal residence.

B. Five years later, the implications of this Act are still being determined as states react to this legislation. Some states aggressively enforce the requirements of the SCRA (e.g. shared legal residency) while others do not inquire into the spouse's claim of protection. In the meantime, spouses who are physically present in a state with the intent to make the state their permanent home should make every effort to substantiate their claim, which may later be challenged by a state (e.g., for state income tax purposes). Such efforts include becoming licensed, buying real property, voting, and registering motor vehicles in the State that they claim to be their domicile. In addition, spouses should express their intent by letting people know that they intend a certain state to be their domicile (e.g., by speaking convincingly of their intent to make the state their domicile).

V. STATE TAXATION OF REAL AND PERSONAL PROPERTY.

A. Ad valorem taxation: "A tax imposed proportionally on the value of something (esp. real property), rather than on its quantity or some other measure." BLACK'S LAW DICTIONARY 1594 (9th ed. rev. 2009).

B. The taxation of real property is not affected by § 571, because real property is taxed where it sits.

C. Ad valorem taxation of personal property.

1. Normally, actual physical situs controls.

2. The Servicemember's personal property.

a) A Servicemember's solely owned personal property, however, is deemed to be located in the Servicemember's state of domicile, and only the state of domicile can tax it. 50 U.S.C. App. § 571.

(1) United States v. Arlington Co., Va., 326 F.2d 929 (4th Cir.1964) - Naval officer, domiciliary of New Jersey, stationed in Virginia, but on sea duty, who left family and personal property in Virginia

could not be taxed by Virginia.

(2) Virginia Attorney General Opinion, June 12, 1984 - Although a non-domiciliary Servicemember's personal property may be located in a jurisdiction other than where he/she is stationed, property still exempt from taxation in any jurisdiction of host state. Servicemember stationed in Arlington cannot be taxed on his auto, though solely driven by wife in another city.

b) The Servicemember is absolutely immune from taxation of nonbusiness personal property by the host state regardless of whether the Servicemember pays personal property tax on the property to the state of domicile. *But see* Sullivan v. United States, 395 U.S. 169 (1969); 50 U.S.C. App. § 571 prohibits only annually recurring taxes on property; sales, use or excise tax is permissible.

(1) Sales Tax. See In re Sales/Use Tax December 1983, No. 85-73, 1985 R.I. Tax LEXIS 72 (R.I. Tax Comm'n. 1985) (Servicemembers must pay local sales tax on purchase of motor vehicle).

(2) Use Tax. See Re: Section 58.1-1821 Application Retail Sales and Use Tax, 1994 Va. Tax LEXIS 275 (Va. Tax Comm. 1994) (Servicemember stationed in Virginia purchased furniture in North Carolina but paid no North Carolina sales tax, is subject to Virginia use tax on purchase). See also, VA Stat. § 58.1-603 & 604 (2007) Imposition of Sale and Use Tax.

c) The § 571 protection for a Servicemember's personal property does not apply to property used by the Servicemember for business or income-producing purposes. With respect to such property, situs controls.

3. Personal property solely owned by the Servicemember's spouse.

a) Generally, the traditional rule of situs controls.

b) If, however, the property is located on a military reservation subject to exclusive federal jurisdiction, then the property cannot be taxed by the state in which the reservation is located. The property can, however, be taxed by the spouse's state of domicile.

4. Personal property that is jointly-owned or is community property may be subject to double taxation:

a) By the Servicemember's state of domicile because it is deemed to be located in that state for purposes of personal property taxation.

b) By the state in which it is physically located because situs governs taxation of the spouse's personal property.

c) State taxation schemes.

(1) Some states tax the property at half value.

(2) Some states tax property according to a party's proportionate contribution toward the purchase price.

(3) A few states tax the property at full value. See 1976-77 Va. Op. Atty. Gen. 285 (14 Oct. 76) and 1986 Ariz. Op. Atty Gen. 111 (Op. # I86-092) (25 Aug. 86).

(4) Some do not try to tax it at all: *See* Mississippi Attorney Gen. Opinion, Feb. 27, 1989 - ad valorem taxes may not be levied on autos owned jointly by military and non-military spouses.

VI. MOTOR VEHICLES.

A. The vehicle itself is subject to personal property taxation according to previously stated rules:

1. Vehicles owned solely by a Servicemember are subject to ad valorem personal property taxation only by the Servicemember's state of domicile.

2. Jointly owned and community property state vehicles may be subject to double personal property taxation. (Problem in community property states such as Arizona, California, Louisiana, New Mexico, and Texas.)

B. Motor vehicle fees - conditional immunity.

1. In determining whether a charge assessed by the duty state is a personal property tax or a license, fee, or excise tax, look behind the label attached to the charge.

a) Sullivan v. United States, 395 U.S. 169 (1969). Section 571 protects from annually recurring property taxes; use or excise tax is permissible.

b) California v. Buzard, 382 U.S. 386 (1966). State barred from exacting a license fee based on percentage of auto's value. California's two percent tax not essential to registration and licensing vehicle.

c) U.S. v. City of Highwood, 712 F.Supp. 138 (N.D. Ill. 1989), motion to reconsider denied, 1989 WL 65043 (N.D. Ill. 9 June 1989) – SSCRA exempts nonresident Servicemembers from annual revenue raising vehicle fees of host state but not from licensing, fees, or excises essential to functioning and administration of licensing and registration laws. *See also*, Karsten v. Riley County Kansas, 924 P.2d 1272 (1996).

d) United States v. Wyoming, 402 F.Supp. 229 (D. Wyo. 1975). Annual registration fee measured by value of vehicle raised revenues and was barred by SSCRA.

2. Pursuant to police powers, states can require compliance with pollution abatement and safety inspection laws even for motor vehicles not subject to state personal property tax and registration requirements.

C. House trailers and mobile homes.

1. Classification as real property v. personal property under federal law will determine taxation status.

a) Snapp v. Neal, 382 U.S. 397 (1966) (state barred from exacting ad valorem tax on house trailer provided Servicemember complies with laws of home state).

b) United States v. Champaign Co. Ill., 525 F.2d 374 (7th Cir. 1975). (SSCRA protection not limited to ad valorem taxes only, but also to annually recurring taxes based on location or situs of property i.e., the mobile home).

c) United States v. Illinois, 387 F.Supp. 638 (E.D.Ill. 1975) (mobile home privilege tax barred regardless of whether home state taxes the property).

d) United States v. Chester Co. Bd. of Assess. & Rev. of Taxes, 281 F.Supp. 1001 (E.D. Pa. 1968) (nonresident Servicemembers' house trailers not permanently affixed to ground were personal property exempt by SSCRA).

e) Arizona Attorney General Opinion, Aug. 25, 1986 - Whether mobile home is real or personal property for purposes of SSCRA is question of federal law. It is personal if it retains characteristics of mobility.

f) Virginia Attorney General Opinion, March 1, 1982 - Nonresident military member exempt from personal property tax on mobile home, though real estate upon which it sits is taxable by host state.

g) Like a motor vehicle, a mobile home will receive ***only conditional immunity*** from licensing and fee requirements of the duty state.

VII. STATE INCOME TAXATION SCHEMES.

A. Most states that have an income tax use one of five basic methods to determine tax liability.

1. Federal adjusted gross income (e.g., Virginia).

2. Federal taxable income (e.g., Colorado).

3. Gross income, but the types of income and adjustments are similar or exactly the same as comparable items on the Federal return (e.g., Pennsylvania).

4. Intangibles only, e.g., interest, dividends, business income, capital gains, and income from rentals or income producing property (e.g., Tennessee).

5. As a percentage of the federal tax liability (e.g., Vermont).

B. The states vary after this

1. The vast majority allow deductions for personal exemptions and most allow either a standard deduction or itemized deductions (usually similar to the Federal itemized deductions) and credits (usually similar to the Federal credits).

2. The states will typically have additions to and subtractions from the basic AGI and these vary tremendously from state to state.

3. Many states offer special tax breaks for members of the military.

C. State Income Tax Rates Vary Greatly.

D. Joint returns.

1. Some states prohibit a joint state return even though the taxpayers file a joint Federal return when the military member has no income from that state (e.g., Virginia).

2. Some states require a joint state return when the taxpayers file a joint Federal return even though the military member has no income from that state (e.g., Kansas).

VIII. CONCLUSION.

APPENDIX A

WHAT IS THE DEFINITION OF "LEGAL RESIDENCE"?

By LTC Michael Brawley, Fort Sheridan Staff Judge Advocate
[Reprinted from the ***Fort Sheridan Tower***, 28 February 1988, with permission of the author.]

Soldiers and their family members are often faced during an Army career with the difficult problem of determining where they have established their "legal residence," also called "domicile." Your legal residence very often controls where you must pay taxes or vote and where your children are entitled to in-state college tuition rates.

Part of the problem in dealing with "legal residence" and the privileges and obligations flowing therefrom stems from the use of inaccurate, ambiguous, and confusing terminology. The terms "residence," "legal residence," "domicile," "resident," "home of record," "home state," and "home" are often spoken interchangeably and inaccurately by tax bureaucrats, civilians, soldiers, and also used incorrectly in various legal documents that touch each soldier's personal affairs every day of his life. I will try to cut through the confusion and provide some clarification on the use of these terms and their legal significance for the soldier or family member.

"Legal residence" means that you are considered a citizen of that particular state. This status is normally acquired by your physical presence within the state, coupled with a desire to be a permanent legal resident, or citizen of that state, as evidenced by the acquisition of those indicators which demonstrate your intent, e.g., registering to vote, buying property, opening bank accounts in local banks, registering your car in the state, acquiring a state driver's license, and paying state income taxes or personal property taxes.

Once acquired, your legal residence remains the same, even if you are moved to another state on military orders, until such time as you desire to, or circumstances, change it.

Suppose you grew up and always lived in California; that state would be your legal residence. If you move on military orders from your state of legal residence (California) to Illinois, you have the option of keeping California as your legal residence or adopting Illinois.

If you adopt Illinois as your new legal residence, you can enjoy the benefits of citizenship here (e.g., voting, no income tax on military pay), but you must also accept the burdens (e.g., changing your driver's license and auto tags to Illinois, and losing California in-state tuition rates for your children's college education).

You normally cannot have your cake and eat it too.

You cannot take the benefits here, and in California, and avoid the burdens in both places. That would be playing “fast and loose” and you could lose the benefits of both places.

One other thing you cannot do is adopt a state as your legal residence without ever being there. For example, if your legal residence was California and you PCS’d to Illinois, you could not adopt Florida as your legal residence just because it has no state income tax, if you never set foot in Florida.

Most state agencies dealing with you on contested tax issues would reject your claim of Florida legal residence, unless you could demonstrate that you lived in Florida at sometime, and then could show that you made efforts to adopt Florida as your legal residence (see indicators above).

“Domicile” for all intents and purposes, means your legal residence. The two terms may be used interchangeably, however I recommend that you use “”legal residence” rather than domicile because domicile is less well understood by the general public in common conversation.

“Residence” and “reside” are another pair of words you encounter frequently. Unless elaborated upon, these terms used alone are capable of causing considerable misunderstanding depending upon the perceptions of those who use them, and those who hear them.

In one usage, “residence” is a dwelling unit, such as a house. Someone who is talking about your "legal residence" can however, also use it. When questioned by someone using this term, always ask how the term is being used. The simple question, “Where do you reside?” can mean either “Where do you live right now?” or “Where is your legal residence?” It is essential to seek clarification when “residence” or “reside” are used because the connotations can have significant legal consequences for you. If you intend to refer to your legal residence, always use the modifier “legal” for clarity’s sake.

“Home of Record” (HOR) is a term of some military significance, but not necessarily any legal consequence. HOR is the place from which you were appointed, enlisted or ordered to active duty for military service. It is used by the Army to determine your maximum travel entitlement upon ETS. It could be the same place as your state of legal residence, but it need not be. Suppose you were attending school away from your state of legal residence, and you were commissioned in ROTC and ordered to active duty at that location. Your HOR for purposes of ordering you to active duty could be State College, Pennsylvania, even though you were a legal resident of California and still nurtured a burning desire to return to the Golden State.

As mentioned earlier, Army travel and transportation allowances are based upon HOR when separation from service occurs. Thus, if your HOR is State College, Pennsylvania, and you are going to ETS at Fort Devens, Massachusetts, Uncle Sam will not ship your household goods (HHG) to California for free, or pay your travel for that distance. Your travel allowance limit would be the distance between Fort Devens and State College, Pennsylvania.

Once designated, the HOR is difficult to change for convenience of the soldier, i.e., to pay for transportation of HHG to a point beyond the distance from separation point to HOR is not allowed.

The term HOR is used interchangeably sometimes with "home" or "home state." The term "home" or "home state" depending upon the intent of the speaker, can mean a "house" or "legal residence," or merely the state from which you originally came.

Again, caution should be used when the words "home" or "home state" are being used. "Where is your home?" is a question as innocent or as loaded as the circumstances under which it is being asked may reflect.

The message here should be clear. Always take care when talking about or filling out documents **that refer to "residence", "home state", "resident of", "living at", "home", "domiciliary of", or "legal residence."**

Many times people ask what are the best indicators of legal residence. I think it safe to say that those indicators, which cost you something probably, demonstrate your intent to be a permanent legal resident of a state better than anything else does. For example, filing state tax returns and, when necessary, paying state income taxes, will go a long way in convincing *state* officials that you really do consider state X to be your legal residence. Voting in a particular state over an extended period, or a career, can also be convincing.

Of less consequence would be owning investment property in a state; and still less important would be maintaining bank accounts or CD's in a particular state.

The more indicators of permanent legal residence you established, which are consistent with an intent to return to particular state when you are separated from the military, the easier it will be to convince interested state authorities of the bone fide nature of your claim to citizenship or, as the case may be, to your denial of citizenship in a particular state.

An interesting sidelight is the status of the wife of a soldier. Under common 1aw, and **still** in some states today, a woman's domicile or legal residence is considered to be that of her husband.

The women's liberation movement has made some in-roads into the archaic legal fiction that held that the wife *is* a "chattel" or "property" of the husband, however, the soldier's *wife* should *be* aware that this concept could be an issue for her at sometime *duri*ng the soldier's career.

The spouse of a soldier should be aware that the protections of the Soldier's and Sailor's Civil Relief Act, ***do not*** shield the family members in all circumstances nearly as well as they do the soldier. For example, while a soldier can retain his home state driver's license *and auto* tags while stationed in a duty state, his spouse within a short time after arrival in the state, would normally have to change the tags on her car, *and* her driver's license over to the duty state where the soldier is stationed.

Another question frequently arises, namely that of re-establishing your legal residence in state X after you have changed it to state Y for some reason.

Can you simply retake your old legal residence when it is to your advantage to do so, or must you again have a physical presence within state X before you can again consider it to by your legal residence?

I can give no definite answer here. In most cases, no evidence of your change from State X to Y is likely to exist unless you vote in state Y or voluntarily file legal documents there, such as, tax returns.

If the validity of your change of legal residence is raised by state authorities, you may be required to show that you re-established legal residence via a new presence within State X and that you took actions which would be persuasive indicators of your true intention or re-establishing of citizenship there.`

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If the validity of your change in legal residence *is* raised by state authorities, you may be required to show that you re-established legal residence via a new presence within State X and that you took *actions* which would be persuasive indicators of your true intention or re-establishing of citizenship there.

APPENDIX B

STATE OF LEGAL RESIDENCE CERTIFICATE

DATA REQUIRED BY THE PRIVACY ACT OF 1974

AUTHORITY:	Tax Reform Act of 1976, Public Law 94-455.
PURPOSE:	Information is required for determining the correct State of legal residence for purposes of withholding State income taxes from military pay.
ROUTINE USES:	Information herein will be furnished State authorities and to Members of Congress.
MANDATORY OR VOLUNTARY DISCLOSURE:	Disclosure is voluntary. If not provided, State income taxes will be withheld based on the tax laws of the State previously certified as your legal residence, or in the absence of a prior certification, the tax laws of the applicable State based on your home of record.

NAME *(Last, first, middle initial)*	**SOCIAL SECURITY NUMBER** *(SSN)*

LEGAL RESIDENCE/DOMICILE *(City or county and State)*

INSTRUCTIONS FOR CERTIFICATION OF STATE OF LEGAL RESIDENCE

The purpose of this certificate is to obtain information with respect to your legal residence/domicile for the purpose of determining the State for which income taxes are to be withheld from your "wages" as defined by Section 3401(a) of the Internal Revenue Code of 1954. PLEASE READ INSTRUCTIONS CAREFULLY BEFORE SIGNING.

The terms "legal residence" and "domicile" are essentially interchangeable. In brief, they are used to denote that place where you have your permanent home and to which, whenever you are absent, you have the intention of returning. The Soldiers' and Sailors' Civil Relief Act protects your military pay from the income taxes of the State in which you reside by reason of military orders unless that is also your legal residence/domicile. The Act further provides that no change in your State of legal residence/domicile will occur solely as a result of your being ordered to a new duty station.

You should not confuse the State which is your "home of record" with your State of legal residence/domicile. Your "home of record" is used for fixing travel and transportation allowances. A "home of record" must be changed if it was erroneously or fraudulently recorded initially.

Enlisted members may change their "home of record" at the time they sign a new enlistment contract. Officers may not change their "home of record" except to correct an error, or after a break in service. The State which is your "home of record" may be your State of legal residence/domicile only if it meets certain criteria.

The formula for changing your State of legal residence/domicile is simply stated as follows: physical presence in the new State with the simultaneous intent of making it your permanent home and abandonment of the old State of legal residence/domicile. In most cases, you must actually reside in the new State at the time you form the intent to make it your permanent home. Such intent must be clearly indicated. Your intent to make the new State your permanent home may be indicated by certain actions such as: (1) registering to vote; (2) purchasing residential property or an unimproved residential lot; (3) titling and registering your automobile(s); (4) notifying the State of your previous legal residence/domicile of the change in your State of legal residence/domicile; and (5) preparing a new last will and testament which indicates your new State of legal residence/domicile. Finally, you must comply with the applicable tax laws of the State which is your new legal residence/domicile.

Generally, unless these steps have been taken, it is doubtful that your State of legal residence/domicile has changed. Failure to resolve any doubts as to your State of legal residence/domicile may adversely impact on certain legal privileges which depend on legal residence/domicile including among others, eligibility for resident tuition rates at State universities, eligibility to vote or be a candidate for public office, and eligibility for various welfare benefits. If you have any doubt with regard to your State of legal residence/domicile, you are advised to see your Legal Assistance Officer (JAG Representative) for advice prior to completing this form.

I certify that to the best of my knowledge and belief, I have met all the requirements for legal residence/domicile in the State claimed above and that the information provided is correct.

I understand that the tax authorities of my former State of legal residence/domicile will be notified of this certificate.

SIGNATURE	**CURRENT MAILING ADDRESS** *(Include ZIP Code)*	**DATE**

DD Form 2058, FEB 77 (EG) Designed using Perform Pro, WHS/DIOR, Jul 94

APPENDIX C

WRITTEN BEFORE THE MSRRA WAS ENACTED

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Department of the Army Pamphlet 27-50-297
TJAGSA Practice Note: Legal Assistance Item
Tax Law Note

NONMILITARY SPOUSE'S JOINT OWNERSHIP OF PERSONAL PROPERTY VOIDS SOLDIERS' AND SAILORS' CIVIL RELIEF ACT PERSONAL PROPERTY TAX PROTECTION

Lieutenant Colonel Conrad

Opinions and conclusions in articles published in the Army Lawyer are solely those of the authors. They do not necessarily reflect the views of the Judge Advocate General, the Department of the Army, or any other government agency.

Legal assistance attorneys should advise their clients that the Soldiers' and Sailors' Civil Relief Act (SSCRA) only protects Servicemembers from multiple state personal property or ad valorem taxation. [FN57] Normally, individual personal property is taxed where it sits (situs). [FN58] The SSCRA provides the legal fiction that a military member's personal property which is titled solely in the name of the Servicemember is sited in the state of domicile and can only be taxed by that state. [FN59] Further, the host state, where the Servicemember is stationed on military orders, may not tax a military member's personal property just because the domiciliary state did not tax the personal property. [FN60]

In contrast to military members, a nonmilitary spouse receives no SSCRA protection from multiple state personal property taxation for property titled solely in the nonmilitary spouse's name or any property titled jointly in the names of the Servicemember and the nonmilitary spouse. [FN61] No reported appellate case has considered the issue of whether the SSCRA tax protections apply to nonmilitary spouses. Nonmilitary spouses can be taxed on their solely owned or jointly held personal property in the state where the property is physically located as well as in the state where the nonmilitary spouse is domiciled. [FN62] Community property states, such as California, do not fit neatly into the traditional common law concepts of joint tenancy or tenancy in common ownership. The rights of husband and wife regarding title to personal property vary from *25 state to state depending on how each state interprets its statutory community property system. [FN63]

The most common problem area regarding personal property is whether a host state may tax motor vehicles titled jointly in the names of a military member and a nonmilitary spouse. The

majority of states that utilize a personal property tax follow a policy of taxing jointly titled motor vehicles where one of the title holders is a military member. [FN64] The taxation formulas vary from state to state, ranging from half value to full value. [FN65] Only a few states do not attempt to tax jointly-held motor vehicles or other personal property owned in part by a military member and a nonmilitary spouse. [FN66]

What does this mean for legal assistance clients? Attorneys should advise their clients to title their motor vehicles, camping trailers, and boats solely in the military member's name. The SSCRA tax protection statute (Section 514) was enacted in the 1940s, when women did not have equal property rights to men and most military spouses did not work outside the home. Today, it is not uncommon for a nonmilitary spouse to work outside the home, and two income military families are the norm. Congress has not extended the SSCRA tax protections to nonmilitary spouses. Until Congress acts, military families should keep their taxable personal property titled solely in the military member's name, if they wish to avoid host state taxation. Lieutenant Colonel Conrad.

FN57. Soldiers' and Sailors' Civil Relief Act (SSCRA), ch. 888, 54 Stat. 1178 (1940) (codified as amended at 50 U.S.C. App. §§ 501-593 (1996)). Section 514 of the SSCRA, dealing with multiple state income and personal property taxation of Servicemembers, was added by the Soldiers' and Sailors' Civil Relief Act Amendments of 1942, ch. 581, § 17, 56 Stat 777; and was subsequently amended further by ch. 397, § 1, 58 Stat. 722 (1994); Pub. L. No. 87-771, 76 Stat. 768 (1962); and Pub. L. No. 102-12, § 9(24), 105 Stat. 41 (1991) (codified at 50 U.S.C. App. § 574). As to personal property taxes, SSCRA § 514, states:

> (1) For the purposes of taxation in respect of any person, or of his personal property ... by any State, Territory, possession, or political subdivision of any of the foregoing, or in the District of Columbia, such person shall not be deemed to have lost a residence or domicile in any State, Territory, possession, or political subdivision of any of the foregoing, or in the District of Columbia, solely by reason of being absent therefrom in compliance with military or naval orders, or to have acquired a residence or domicile in, or to have become a resident in or a resident of, any other State, Territory, possession, or political subdivision of any of the foregoing, or the District of Columbia, while, and solely by reason of being, so absent. For the purposes of taxation in respect of the personal property ... of any such person by any State, Territory, possession, or political subdivision of any of the foregoing, or the District of Columbia, of which such person is not a resident or in which he is not domiciled ... personal property shall not be deemed to be located or present in or to have a situs for taxation in such State, Territory, possession, or political subdivision or district. Where the owner of personal property is absent from his residence or domicile solely by reason of compliance with military or naval orders, this section applies with respect to personal property, or the use thereof, within any tax jurisdiction other than such place of residence or domicile, regardless of where the owner may be serving in compliance with such orders: provided, that nothing contained in this section shall prevent taxation by any State, Territory, possession, or political subdivision of any of the foregoing, or the District of Columbia in respect of personal property used in or arising from a trade or business, if it otherwise has jurisdiction.
> (2) When used in this section, (a) the term 'personal property" shall include tangible and intangible property (including motor vehicles).

FN58. SSCRA § 514.

FN59. Id.

FN60. Dameron v. Brodhead, 345 U.S. 322 (1953).

FN61. SSCRA § 514. This section provides no statutory protection against multiple state taxation of the income and personal property of nonmilitary spouses. But cf. SSCRA § 536 (explicitly setting forth SSCRA protections that apply to nonresident military spouses as to leases, mortgages, and contracts); Brunson v. Chamberlina, 53 N.Y.S.2d 172 (N.Y. Mun. Ct. 1945); Wanner v. Glen Ellen Corporation, 373 F. Supp. 983 (D. Vt. 1974). See also 1986 Op. Ariz. Att'y Gen.

111 (1986); Op. S.C. Att'y Gen. 3000 (1970); 1984-85 Op. Va. Att'y Gen. 363 (1984); 1976-77 Op. Va. Att'y Gen. 285 (1976).

FN62. 1983-84 Op. Va. Att'y Gen. 393 (1984).

FN63. 1976-77 Op. Va. Att'y Gen. (1976). 15 AM. JUR. 2D Community Property § 1 (1964). The following states have adopted some sort of community property system: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

FN64. See 1986 Op. Ariz. Att'y Gen. 111 (1986); Op. S.C. Att'y Gen. 3000 (1970); 1984-85 Op. Va. Att'y Gen. (1984); and 1976-77 Op. Va. Att'y Gen. 285 (1976).

FN65. See Comment, State Power to Tax the Servicemember: An Examination of Section 514 of the Soldiers' and Sailors' Civil Relief Act, 36 MIL. L. REV. 123 (1967). The State of Virginia taxes the full value of personal property held in the joint names of a military member and the nonmilitary spouse. See 1976-77 Op. Va. Att'y Gen. 285 (1976).

FN66. 1989 Op. Miss. Att'y Gen (1989).

APPENDIX D

Army Lawyer
July, 2006

2006 Army Law. 27

TJAGLCS PRACTICE NOTES (THE JUDGE ADVOCATE GENERAL'S LEGAL CENTER AND SCHOOL): Servicemembers Civil Relief Act Note: Staying Connected: "Home of Record" Not Always the Same as "Domicile" Under the Servicemembers Civil Relief Act's Taxation Protections

Lieutenant Colonel Jeffrey P. Sexton: Vice Chair and Professor, Administrative and Civil Law Department, The Judge Advocate General's Legal Center and School, Charlottesville, Virginia.

[*27] Most servicemembers are generally familiar with the rule under the Servicemembers Civil Relief Act n1 (SCRA) that military income is taxable only by the servicemember's state of domicile and not by the state where the servicemember is assigned. n2 The rule derives from section 571 of the SCRA and its predecessor section under the venerable Soldiers' and Sailors' Civil Relief Act (SSCRA). n3 Unfortunately, servicemembers and their family members frequently misunderstand the limited scope of taxation protections under the SCRA n4 and fail to grasp the implications of wrongly applying ambiguous and confusing terminology such as "domicile" n5 and "residence." n6 A recent case in the Oregon Tax Court demonstrates how servicemembers and the states do not always agree on the definitions and use of such terms n7 and underscores the continuing need for servicemembers to consider the potential tax consequences of their connections and associations, or lack thereof, with their home state and their state of assignment.

In *Carr v. Department of Revenue*, n8 the Oregon Tax Court held that a Navy servicemember was not relieved from responsibility to pay Oregon state income tax merely by asserting that his home of record n9 with the Navy was in Nevada. In 1980, Senior Chief Martin Carr n10 enlisted in the United States Navy and listed an address in Nevada as his home of record. n11 He continued to list Nevada as his home of record through twenty-five years of active duty service. From 1993 to 1996, [*28] Senior Chief Carr was assigned to duty in Portland, Oregon. In 1999, he was reassigned to Oregon, where he resided with his wife. n12 The Carrs' connections to Oregon included purchasing a home in the state in 2001 and registering their vehicles there. n13 Senior Chief Carr was not registered to vote in Oregon, did not have an Oregon driver's license, and stated "unequivocally, and repeatedly" that he had no intention of making Oregon his domicile. n14 Despite this, the State of Oregon assessed personal income taxes against Senior Chief Carr for the 2001, 2002, and 2003 tax years. n15

At first glance, Senior Chief Carr's connections and associations with Oregon appear to be no different from the actions of thousands of servicemembers throughout the U.S. armed forces with regard to their host (duty) states. It is common for Soldiers, Sailors, Airmen, and Marines to purchase homes and register vehicles in their state of military assignment, but these servicemembers typically still consider themselves "domiciled" for military and tax purposes in their home state. Most of these servicemembers would also honestly assert that upon separating

from the military, they intend to return to their home state. This "intention to return" is a key factor when evaluating where a servicemember is domiciled for purposes of the taxation protections of the SCRA. If the common definition of domicile includes an "intent to return and remain," n16 then the servicemember's stated "intention to return" (the presumptive equivalent of an "intention to remain") goes a long way to support the proposition that the servicemember is still domiciled in his home state. Further, purchasing homes and registering vehicles in the host state are not necessarily determinative. In fact, the Oregon Tax Court specifically stated that the acts of purchasing a home or registering a vehicle are not "conclusive in themselves" to establish that the servicemember had an intention to remain in the host state. n17 So why, despite Senior Chief Carr's lack of stated intent to make Oregon his domicile and his relatively unremarkable connections to Oregon, did the court conclude that he was domiciled in Oregon?

In determining Senior Chief Carr's domicile, the decisive factor for the Oregon court was not his connections *to* Oregon, but rather his *lack of* connections to his purported home state of Nevada. The court found that Senior Chief Carr did not own property in Nevada, did not have a Nevada driver's license, did not vote in Nevada, did not register his vehicles in Nevada, had only some extended family members in Nevada, and did not "speak convincingly of an intention to return to Nevada." n18 These points convinced the court that Senior Chief Carr and his wife had no current connection to the State of Nevada that would support his claim of Nevada domicile. n19 Although the court acknowledged that the Carr's connections to Oregon were "by themselves equivocal," n20 it stated that those connections (purchasing a home and registering vehicles) "stand . . . as the best indicators of that place which . . . Plaintiffs had the intention to return when they were absent." n21

The teaching point for legal assistance attorneys advising servicemembers on these issues is that the "bare assertion" n22 of a home of record address is not enough to establish *and maintain* domicile for purposes of taxation protection under the SCRA. Although a servicemember may have entered military service from a certain state and listed that state as the home of record for many years, those facts alone do not establish the servicemember's *current* domicile. n23 Similarly, because a servicemember adopted a new state of domicile during a previous military assignment does not mean that the state will *remain* the state of domicile for future assignments. States such as Oregon n24 will look at all of the servicemember's connections to determine which state is the "strongest of all their associations." n25 As a result, servicemembers seeking to [*29] maintain a current state of domicile or acquire a new state of domicile would be wise to establish as many connections and associations with that state as possible. n26

FOOTNOTES:

n1 *50 U.S.C.S. App. §§ 501*-596 (LEXIS 2006).

n2 The rule stems from the joint application of two subsections of the SCRA found at *50 U.S.C.S. app. § 571*(a) and (b). The first subsection essentially states that a servicemember neither acquires nor loses domicile for taxation purposes solely by being assigned to military duty outside his home state. The second subsection generally asserts the statutory "fiction" that a servicemember's income is deemed earned in the state of domicile, even though the servicemember is performing duty in another state. The pertinent subsections are as follows:

(a) Residence or domicile. A servicemember shall neither lose nor acquire a residence or domicile for purposes of taxation with respect to the person, personal property, or income of the servicemember by reason of being absent or present in any tax jurisdiction of the United States solely in compliance with military orders.

(b) Military service compensation. Compensation of a servicemember for military service shall not be deemed to be income for services performed or from sources within a tax jurisdiction of the United States if the servicemember is not a resident or domiciliary of the jurisdiction in which the servicemember is serving in compliance with military orders.

n3 Soldiers' and Sailors' Civil Relief Act, *50 U.S.C. app. §§ 501*-594 (2000) (current version at *50 U.S.C.S. app. §§ 501*-596 (LEXIS 2006)).

n4 For example, servicemembers may wrongly believe that their military income is "exempt from all taxation, to include taxation by their state of domicile," and that "the SCRA exempts their nonmilitary income from taxation." *See* ADMINISTRATIVE & CIVIL LAW DEP'T, THE JUDGE ADVOCATE GENERAL'S LEGAL CENTER & SCHOOL, U.S. ARMY, JA 260, THE SERVICEMEMBERS CIVIL RELIEF ACT GUIDE 5-3 (Mar. 2006).

n5 Domicile is defined as "[a] person's true, fixed, principal, and permanent home, to which that person intends to return and remain, even though currently residing elsewhere." BLACK'S LAW DICTIONARY 501 (7th ed. 1999).

n6 Residence is defined as "[t]he place where one actually lives, as distinguished from a domicile." BLACK'S LAW DICTIONARY 1310. Residence differs from domicile in that it usually does not require "an intent to make the place one's home." *Id.* On the other hand, the term "legal residence" is generally considered to be synonymous with domicile. *See id.* at 907; *see also* U.S. Dep't of Defense, DD Form 2058, State of Legal Residence Certificate (Feb. 1977) [hereinafter DD Form 2058] (stating that the terms "legal residence" and "domicile" are essentially interchangeable).

n7 For a detailed discussion of terms commonly used in the military such as "domicile," "residence," and "home of record," and the consequences to servicemembers of the misuse of these terms, see Major Wendy P. Daknis, *Home Sweet Home: A Practical Approach to Domicile, 177 MIL. L. REV. 49 (2003).*

n8 *Carr v. Dep't of Revenue, 2005 Or. Tax LEXIS 223 (Or. Tax 2005).*

n9 The term "home of record" is generally considered to have no legal significance. It is used to establish military travel and transportation allowances and is not to be confused with a servicemember's state of legal residence or domicile. *See* DD Form 2058, *supra* note 6.

n10 Senior Chief Carr's full military rank is Senior Chief Petty Officer, which is equivalent to the military pay grade E-8.

n11 *Carr*, 2005 Or. Tax LEXIS, at *1.

n12 Senior Chief Carr apparently remained assigned for military duty in Oregon as the case went up on appeal to the Oregon Tax Court.

n13 *Carr*, 2005 Or. Tax LEXIS, at *2.

n14 *Id.* at *1, *5.

n15 *Id.* at *1.

n16 BLACK'S LAW DICTIONARY 501 (7th ed. 1999). Also, the Supreme Court has defined domicile as: "A residence at a particular place accompanied with positive or presumptive proof of an intention to remain there for an unlimited time." *Mitchell v. United States, 88 U.S. 350, 352 (1874).*

n17 *Carr*, 2005 Or. Tax LEXIS, at *6.

n18 *Id.* at *5.

n19 *Id.*

n20 *Id.*

n21 *Id.* at *6.

n22 *Id.*

n23 The *Carr* court emphasized that "a person can have only one domicile at a time." *Id.* at *5; *see also In re Estate of Jones, 182 N.W. 227, 228 (Iowa 1921); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 11* (1971); BLACK'S LAW DICTIONARY 1310 (7th ed. 1999) (defining residence).

n24 The *Carr* court pointed out that other jurisdictions, such as New Jersey and Minnesota, have applied similar reasoning in evaluating whether a servicemember was domiciled in the state of assignment and not in the home state. *Carr*, 2005 Or. Tax LEXIS, at *6 (citing Wolff v. *Baldwin, 9 N.J. Tax 11 (N.J. Tax Ct. 1986) and U.S. v. Minnesota, 97 F. Supp. 2d 973 (D. Minn. 2000).*

n25 *Carr*, 2005 Or. Tax LEXIS, at *5.

n26 Common examples of the types of activities a servicemember should consider taking to establish and maintain domicile in a particular state include: purchasing land or a home in the state, registering to vote, registering vehicles, opening a bank or investment account in the state, obtaining a driver's license, joining a church or other service/fraternal organizations, and purchasing a burial plot. *See* Daknis, *supra* note 7, at 78 (providing these and other examples but emphasizing that the list is not exhaustive, and pointing out that the servicemember must also meet the threshold requirement of establishing a physical presence in the state).

APPENDIX E

Army Lawyer
January, 2010

Department of the Army Pamphlet 27-50-440
Administrative and Civil Law Edition
Article

*52 SETTING SERVICEMEMBERS UP FOR MORE SUCCESS: BUILDING AND TRANSFERRING WEALTH IN A CHALLENGING ECONOMIC ENVIRONMENT--A TAX AND ESTATE PLANNING ANALYSIS

Major Samuel W. Kan [FNa1]

Opinions and conclusions in articles published in the Army Lawyer are solely those of the authors. They do not necessarily reflect the views of the Judge Advocate General, the Department of the Army, or any other government agency.

2. State Income Tax

As states increasingly face "devastating" deficits, [FN42] the state taxing authorities have increasingly become concerned with residents who have neither filed nor paid state income tax. [FN43] On one hand, military members who are ordered to move to a ***57** new state may establish sufficient connections to the new state to justify the imposition of that state's income tax. On the other hand, military members who had a prior connection with a state before entering active duty service may appear to have neglected the payment of state tax, when, in fact, these servicemembers legally changed their state of domicile. In short, military members must be vigilant in understanding the meaning of domicile [FN44] and documenting the factors that prove their domicile. This section explores the fundamental distinctions.

a. Military Pay

In addition to paying federal income tax, many servicemembers must consider state income taxes, depending on their state of domicile. [FN45] A servicemember can establish a state as their domicile based on their physical presence in the state and their intent to make the state their permanent home. [FN46] Servicemembers may reap significant tax benefits based on the tax laws of their state of domicile because some states, like Texas, Nevada, and Florida, have no state income tax. In addition, other states exclude some or all military pay from income tax (see Appendix E). [FN47]

To establish and maintain domicile, servicemembers must take specific steps to demonstrate their intent to make a state their permanent home rather than engaging in subterfuge to avoid paying state income tax. [FN48] First, after establishing physical presence in the state, servicemembers should visit their local finance office and fill out appropriate paperwork, such as the DD Form 2058, *State of Legal Residence Certificate*. [FN49] Second, servicemembers

should establish as many ties as possible to the state, such as registering to vote, purchasing real property, and obtaining professional and driver's licenses within the state. Third, servicemembers should express their desire to make the state their permanent home by telling others, such as friends and family, about their intent.

Servicemembers must exercise caution due to the variations in state law [FN50] and level of aggressive enforcement by state revenue collection authorities. For example, in *Carr v. Dep't of Revenue*, the court held that a servicemember had no connection to Nevada, his claimed state of domicile, but had sufficient nexus [FN51] to the State of Oregon even though he was not registered to vote in Oregon, had no Oregon driver's license, and had no intent to remain in Oregon once his military obligation was completed. [FN52] As a result of his connections to Oregon, including the purchase of a home and registering vehicles in Oregon, and, more importantly, his lack of current connections to Nevada, the court held that the servicemember was liable for paying Oregon's state income tax on his military income. [FN53]

***58** *b. Non-Military (i.e., Civilian) Income*

Although military income may not be subject to state income tax in certain states, non-military income of servicemembers and their spouses may be subject to state income tax based on the location where the income is earned. For example, if a servicemember owns rental property in a state that imposes state income tax, the servicemember may be obligated to file a non-resident income tax return for the state in which the rental income was earned. Similarly, if the servicemember receives compensation from a non-military job, the servicemember may need to file a state income tax return.

In a very important statutory development, civilian spouses who meet the domicile test of physical presence and the intent to make a state their permanent home can now receive protections similar to servicemembers due to the Military Spouses Residency Relief Act (MSRRA). [FN54] As a result of this Act, as of 2009, if military members and their spouses each separately establish and maintain domicile in the same state, they can keep this domicile even though they later move together upon the receipt of military orders to a new state.

For example, a servicemember and a civilian spouse may establish Texas as their domicile if both are physically present in Texas, express the intent to make Texas their domicile, and establish their own contacts to Texas, such as purchasing real property, voting, and becoming licensed in Texas. If the servicemember receives orders to move to Virginia and the spouse moves with the servicemember solely to be together, both can maintain Texas as their domicile. If the servicemember's spouse gets a civilian job in Virginia, the spouse can assert the MSRRA claiming Texas as the state where the spouse established and maintains domicile. By asserting and providing appropriate substantiation to this claim, the spouse's civilian pay would not be subject to taxation by Virginia. This result may seem unfair because the civilian pay of a servicemember who obtains civilian employment in Virginia would be subject to Virginia's income tax.

Servicemembers and their spouses should exercise caution because the Act may be interpreted differently by each state as the states react to the new federal legislation. Servicemembers and their spouses should be prepared to provide to their employers, as well as to the state taxing authorities, substantial evidence that they properly established and currently maintain a specific state as their domicile. If the claimed state of domicile has a state income tax, servicemembers and their spouses should ensure that their employers properly withhold the appropriate state's income tax.

Appendix E: State Income Tax (A Quick Reference Guide)

STATE	MILITARY PAY EXCLUDED?	MIL. RETIREMENT PAY EXCLUDED?	CITATION
Alabama	No	Yes	ALA. CODE § 40-18-3 (LexisNexis 2009), ALA. CODE § 40-18-20 (LexisNexis 2009)
Alaska	No State Income Tax	No State Income Tax	ALASKA STAT. § 43.20.010 (2009)
Arizona	Yes [FN286]	Partial [FN287]	ARIZ. REV. STAT. § 43-1022 (LexisNexis 2008)
Arkansas	Partial [FN288]	Partial [FN289]	ARK. CODE ANN. § 26-51-306 (2008), ARK. CODE ANN. 26-51-307 (2008)
California	Yes [FN290]	No	CAL. REV. & TAX. CODE § 17140.5 (Deering 2009)
Colorado	No [FN291]	Partial [FN292]	COLO. REV. STAT. § 39-22-103 (2008), COLO. REV. STAT. § 39-22-112 (2008), COLO. REV. STAT. § 39-22-104 (2008)
Connecticut	Yes [FN293]	No	CONN. GEN. STAT. § 12-701 (2008)
Delaware	No	Partial [FN294]	DEL. CODE ANN. tit. 30, § 1121 (2009), DEL. CODE ANN. tit. 30, § 1106 (2009)
Florida	No State Income Tax	No State Income Tax	FLA. STAT. ANN. *§ 220.02 (LexisNexis 2009)*
Georgia	No	Partial [FN295]	GA. CODE ANN. § 48-7-27 (2009)
Hawaii	No	Yes	HAW. REV. STAT. § 235-2.3 (2009); HAW. REV. STAT. § 235-7 (2009)
Idaho	Yes [FN296]	Partial [FN297]	IDAHO CODE ANN. § 63-3013 (2008), IDAHO CODE ANN. §63-3022A (2008)
Illinois	Yes	Yes	35 ILL. COMP. STAT. ANN. 5/203 (LexisNexis 2009)
Indiana	No	Partial	IND. CODE ANN. § 6-3-2-1 (LexisNexis 2009), IND. CODE ANN. § 6-3-2-3.7 (LexisNexis 2009)
Iowa	No	Partial	IOWA CODE § 422.9 (2008)
Kansas	No	Yes	KAN. STAT. ANN. § 79-32, 117 (2008)
Kentucky	Yes [FN298]	Partial	Joe Biesk, *Income Tax Exemption to Benefit Military Personnel*, DAILY INDEP., July 3, 2009, KY. REV. STAT. ANN. § 141.021 (LexisNexis 2009)
Louisiana	Partial [FN299]	Yes	LA. REV. STAT. ANN. § 47:293 (2009), LA. REV. STAT. ANN. § 47:44.2 (2009)
Maine	No	Partial [FN300]	ME. REV. STAT. ANN. tit. 36, § 5122 (2009)
Maryland	No	Partial [FN301]	MD. CODE ANN., TAX-GEN. § 10-207 (2009)
Massachusetts	No	Yes	MASS. ANN. LAWS ch. 62, § 2 (LexisNexis 2009)
Michigan	Yes	Yes	MICH. COMP. LAWS SERV. § 206.30 (LexisNexis 2009)
Minnesota	Yes [FN302]	No	MINN. STAT. § 290.01 (2008)
Mississippi	No	Yes	MISS. CODE ANN. § 27-7-15 (2008)
Missouri	Yes [FN303]	Partial [FN304]	MO. REV. STAT. § 143.041 (2009), MO. REV. STAT. § 143.123 (2009)
Montana	No	Partial [FN305]	MONT. ADMIN. R. 42.15.219 (2009)
Nebraska	No	No	NEB. REV. STAT. ANN. § 77-2716 (LexisNexis 2009), NEBRASKA DEPT. OF REVENUE, NEBRASKA INCOME TAX FOR MILITARY SERVICEMEMBERS AND CIVILIANS WORKING WITH U.S. FORCES IN COMBAT ZONES 1 (2009), *available at* http://www.revenue.ne.gov/info/8-364.pdf. (last visited Jul. 20, 2009)
Nevada	No State Income Tax	No State Income Tax	Nevada Dept. of Taxation, *available at* http://tax.state.nv.us (last visited Jul. 20, 2009).
New Hampshire	No State Income Tax	No State Income Tax	New Hampshire Dept. of Revenue Administration Taxpayer Assistance, *available at* http://www.nh.gov/revenue/faq/gti-rev.htm (last visited Jul. 20, 2009).
New Jersey	Yes	Yes	N.J. REV. STAT. § 54A:6-26 (2009)
New Mexico	No	No	N.M. ADMIN. CODE § 3.3.4.1-12 (2009), N.M. ADMIN. CODE § 3.3.11.13 (2009)
New York	Yes [FN306]	Yes	N.Y. TAX LAW § 605 (Consol. 2009), N.Y. TAX LAW § 612 (Consol. 2009)
North Carolina	No	Partial [FN307]	N.C. GEN. STAT. § 105-134.6 (2009)
North Dakota	Partial [FN308]	Partial [FN309]	CORY FONG, TAX COMMISSIONER, INCOME TAX TREATMENT OF MILITARY PERSONNEL 5 (n.d.), *available at* http://www.nd.gov/tax/indincome/pubs/guide/gl-28243.pdf (last visited Feb. 4, 2010)
Ohio	Yes [FN310]	Yes [FN311]	OHIO REV. CODE ANN. § 5747.01 (24) (LexisNexis 2009); OHIO REV. CODE ANN. § 5747.01(26) (LexisNexis 2009)
Oklahoma	Yes [FN312]	Partial	S.B. 881, 52nd Legis. Sess., 1st Sess. (Okla. 2009); OKLA. STAT. tit. 68, § 2358 (2009)
Oregon	Partial	Partial	OR. REV. STAT. § 316.791 (2007), Oregon Department of Revenue, Military Personnel Filing Information 150-101-657 (Rev. Jan. 2010), *available at*

			http://egov.oregon.gov/DOR/PERTAX/docs/101-657.pdf (last visited Feb. 22, 2010)
Pennsylvania	Partial	Yes	72 PA. CONS. STAT. § 3402-303 (2009), Pennsylvania Department of Revenue, PA-40 Pennsylvania Personal Income Tax Return 2009, *available at* http://www.portal.state.pa.us/portal/server.pt/community/personal_income_tax/14692 (last visited Feb. 22, 2010)
Rhode Island	No	No	R.I. GEN. LAWS § 44-30-2.6 (2009)
South	No	Partial [FN313]	S.C. CODE ANN. § 12-6-1170 (2008)

Carolina			
South Dakota	No State Income Tax	No State Income Tax	South Dakota Department of Revenue & Regulation, http://www.state.sd.us/drr2 (last visited Jul. 20, 2009)
Tennessee	No State Income Tax	No State Income Tax	Tennessee Dept. of Revenue Frequently Asked Questions, *available at* http://www.tennessee.gov/revenue/faqs/indincome.htm#3 (last visited Jul. 20, 2009)
Texas	No State Income Tax	No State Income Tax	Comptroller of Public Accounts Windows on State Government, *available at* http://www.window.state.tx.us/taxes/ (last visited Jul. 20, 2009)
Utah	No	No [FN314]	UTAH CODE ANN. § 59-10-1019 (2009)
Vermont	Partial	No [FN315]	VT. STAT. ANN. tit. 32, § 5823 (2009), VT. STAT. ANN. tit. 32, § 5824 (2009)
Virginia	Partial [FN316]	Partial [FN317]	VA. CODE ANN. § 58.1-322 (2009)
Washington	No State Income Tax	No State Income Tax	Dept. of Revenue Income Tax, *available at* http://dor.wa.gov/content/FindTaxesAndRates/IncomeTax/ (last visited Jul. 20, 2009)
West Virginia	Yes [FN318]	Partial [FN319]	W. VA. CODE § 11-21-7 (2009), W. VA. CODE § 11-21-12 (2009)
Wisconsin	No	Yes	WIS. STAT. § 71.05 (2008)
Wyoming	No State Income Tax	No State Income Tax	Wyoming Dept. of Revenue, *available at* http://revenue.state.wy.us/ (last visited Jul. 20, 2009)

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[FN42]. *See, e.g.*, Ryan Kost, Oregon State Deficit Could Grow by $1 Billion, *available at* http://www.katu.com/news/local/37747104.html (last visited Jan. 28, 2010).

[FN43]. *See e.g.*, Carr v. Dep't of Revenue, 2005 WL 3047252 (Or. Tax Nov. 4, 2005) (holding a servicemember liable for state income taxes in Oregon, even though the servicemember claimed to be from Nevada, a state without a state income tax).

[FN44]. Domicile is defined as "[t]he place at which a person is physically present and that the person regards as home; a person's true, fixed, principal, and permanent home, to which that person intends to return and remain even though currently residing elsewhere." BLACKS LAW DICTIONARY 501 (7th ed. 1999).

[FN45]. *See generally* Retirement Living, *supra* note 24 (providing various resources relating to individual state requirements).

[FN46]. *See generally* Major Wendy P. Daknis, *Home Sweet Home: A Practical Approach to Domicile*, 177 MIL. L. REV. 49, 52 (2003) (explaining the requirements of establishing domicile).

[FN47]. *See id.* at 102-09 (describing the extent to which each state includes or excludes military pay and military retirement pay). *See also* Major Richard W. Rousseau, *Update: Tax Benefits for Military Personnel in a Combat Zone or Qualified Hazardous Duty Area*, ARMY LAW., Dec. 1999, at 1, 15-29 (describing the extent to which each state taxes combat pay).

[FN48]. *See, e.g.*, Texas v. Florida, 306 U.S. 398 (1939) (discussing subterfuge situations).

[FN49]. U.S. Dept. of Defense, DD Form 2058, State of Legal Residence Certificate (Feb. 1977), *available at* http://www.dtic.mil/whs/directives/infomgt/forms/eforms/dd2058.pdf (last visited on Jan. 28, 2010).

[FN50]. *See e.g.*, *In re* Gatchell (N.Y. Tax Comm. 1984), *available at* http://www.nysdta.org/STC/Personal/1984/a_10170.pdf (last visited Jan. 27, 2010) (establishing that a servicemember who lives in a military barracks does not have a permanent place of abode and thus is not exempt from New York state income tax).

[FN51]. Nexus is defined as "[a] connection or link ...." BLACKS LAW DICTIONARY, *supra* note 44, at 1066.

[FN52]. *See, e.g.*, Carr v. Dep't of Revenue, 2005 WL 3047252 (Or. Tax Nov. 4, 2005) (holding a servicemember liable for state income taxes in Oregon, even though the servicemember claimed to be from Nevada, a state without a state income tax).

[FN53]. *See e.g.*, *id.* The court noted that if the taxpayers had "owned property in Nevada, had Nevada driver's licenses, voted in Nevada, registered their vehicles in Nevada, or spoke convincingly of an intention to return to Nevada, their case would be stronger." *Id.*

[FN54]. 50 App. U.S.C. § 571. The Act, which amended the Servicemembers Civil Relief Act, states:

A spouse of a servicemembers shall neither lose nor acquire a residence or domicile for purposes of taxation with respect to the person, personal property, or income of the spouse by reason of being absent or present in any tax jurisdiction of the United States solely to be with the servicemember in compliance with the servicemember's military orders if the residence or domicile, as the case may be, is the same for the servicemember and the spouse .... Income for services performed by the spouse of a servicemember shall not be deemed to be income for services performed or from sources within a tax jurisdiction of the United States if the spouse is not a resident or domiciliary of the jurisdiction in which the income is earned because the spouses is in the jurisdiction solely to be with the servicemember serving in compliance with military orders.

Id.

[FN286]. ARIZ. REV. STAT. § 43-1022 (Westlaw 2010). Excluded from Arizona state tax is "compensation received for active service as a member of the reserves, the national guard or the armed forces of the United States."

[FN287]. ARIZ. REV. STAT. § 43-1022 (Westlaw 2010). Up to $2500 in military retirement benefits may be excluded for Arizona state tax purposes.

[FN288]. ARK. CODE ANN. § 26-51-306 (Westlaw 2010). Only the first $9000 of active duty pay is exempt.

[FN289]. ARK. CODE ANN. § 26-51-307 (Westlaw 2010). Up to $6000 of pension is excluded.

[FN290]. CAL. REV. & TAX. CODE § 17140.5 (Deering 2009). An individual domiciled in California when entering the military is considered to be a nonresident while stationed outside of California on PCS orders. *See* STATE OF CALIFORNIA FRANCHISE TAX BOARD, FTB PUB. 1032 TAX INFORMATION FOR MILITARY PERSONNEL (2009), *available at* http://www.ftb.ca.gov/forms/2009/09_1032.pdf (last visited Feb. 12, 2010).

[FN291]. COLO. REV. STAT. § 39-22-103 (Westlaw 2010). An individual domiciled in Colorado who Is absent from the state for a period of at least three hundred five days of the tax year and is stationed outside of the United States of America for active military duty may file as a non-resident.

[FN292]. COLO. REV. STAT. § 39-22-104 (Westlaw 2010). Servicemembers age fifty-five to sixty-four may exclude up to $20,000 of their military retirement benefits. Servicemembers age sixty-five and up may exclude up to $24,000.

[FN293]. CONN. GEN. STAT. § 12-701 (Westlaw 2010). A servicemember domiciled in Connecticut may qualify as a non-resident for tax purposes if he meets either of the following requirements: (A) 1. Maintains no permanent place of abode in CT. 2. Maintains a permanent place of abode elsewhere. 3. Spends no more than thirty days of the taxable year in CT. or (B) 1. Within any period of 548 consecutive days, he is not present in the state for more than 90 days and does not maintain a permanent place of abode in CT [with some exceptions].

[FN294]. DEL. CODE ANN. tit. 30, § 1106 (Westlaw 2010). Servicemembers under age sixty may exclude up to $2000 of their pension. Those age sixty and over may exclude up to $12,500.

[FN295]. GA. CODE ANN. § 48-7-27 (Westlaw 2010). For taxable years beginning on or after 1 January 2008, Georgia allows a retirement exclusion of up to $35,000 for individuals age sixty-two or over.

[FN296]. IDAHO CODE ANN. § 63-3013 (Westlaw 2010). Servicemembers who are absent from the state for at least 445 days in a fifteen-month period are not considered residents and do not have to file an Idaho income tax return. This classification does not apply to servicemembers who (1) have a permanent home where their spouses or minor children live for more than sixty days in any calendar year or (2) claim Idaho as their tax home for Federal Income Tax purposes.

Servicemembers regain their resident status when they spend more than sixty days in Idaho in any calendar year.

[FN297]. IDAHO CODE ANN, §63-3022A (Westlaw 2010). Retirement pay is excluded once servicemember reaches age of sixty-five, or sixty-two if disabled.

[FN298]. Joe Biesk, *Income Tax Exemption to Benefit Military Personnel*, DAILY INDEP., July 3, 2009, http://www.dailyindependent.com/statenews/local_ story_184083714.html/resources_printstory. Active duty military pay is exempt for Kentucky state tax purposes starting January 2010.

[FN299]. LA. REV. STAT. ANN. § 293(9)(e) (Westlaw 2010) ("[I]n the case of an individual who is on active duty as a member of the armed forces of the United States, which full-time duty is or will be continuous and uninterrupted for one hundred twenty consecutive days or more, total compensation paid for services performed outside this state by the armed forces of the United States of up to thirty thousand dollars shall be excluded from "tax table income" and is hereby declared exempt from state income taxation."),

[FN300]. ME. REV. STAT. ANN. tit. 36, § 5122 (Westlaw 2010). Servicemembers may deduct up to $6000 of their military pensions.

[FN301]. MD. CODE ANN., TAX-GEN. § 10-207 (Westlaw 2010). The first $5000 of military retired pay may be excluded.

[FN302]. MINN. STAT. § 290.01 (Westlaw 2010). Members of U.S. Armed Forces stationed outside the state are not considered residents for tax purposes.

[FN303]. MO. REV. STAT. § 143.041 (Westlaw 2010). Military pay is not subject to Missouri tax if servicemember is considered a non-resident for tax purposes. He or she must spend less than 30 days in Missouri and not maintain permanent living quarters.

[FN304]. MO. REV. STAT. § 143.123 (Westlaw 2010). Up to $6000 of retirement pay may be excluded.

[FN305]. MONT. ADMIN. R. 42.15.219 (Westlaw 2010). There is a $3600 exclusion, if adjusted gross income is less than $30,000.

[FN306]. N.Y. TAX LAW § 605 (Consol. 2009). Servicemembers are considered non-residents for tax purposes if they fall into either of two groups. Group A: (1) they do not maintain a permanent home in New York, (2) They maintain a permanent home outside New York, and (3) They did not spend more than 30 days in New York during the tax year. Group B: (1) They were in a foreign country for at least 450 out of 548 consecutive days, and (2) spent less than 90 days in a permanent home in New York during that time.

[FN307]. N.C. GEN. STAT. § 105-134.6 (Westlaw 2010). Retirees may deduct up to $4,000 depending on their circumstance.

[FN308]. CORY FONG, TAX COMMISSIONER, INCOME TAX TREATMENT OF MILITARY PERSONNEL 5 (n.d.), *available at* http://www.nd.gov/tax/indincome/pubs/guide/gl-28243.pdf. If resident servicemembers use form ND-2, they may exclude up to $1,000 of military pay. Additionally, they may exclude $300 per month for each month they served overseas.

[FN309]. *Id.* Retirees who are at least fifty years old may exclude up to $5000 of retirement pay.

[FN310]. OHIO REV. CODE ANN. § 5747.01(24) (Westlaw 2010).

Deduct, to the extent included in federal adjusted gross income and not otherwise allowable as a deduction or exclusion in computing federal or Ohio adjusted gross income for the taxable year, military pay and allowances received by the taxpayer during the taxable year for active duty service in the United States army, air force, navy, marine corps, or coast guard or reserve components thereof or the national guard. The deduction may not be claimed for military pay and allowances received by the taxpayer while the taxpayer is stationed in this state.

[FN311]. *Id.*

Deduct, to the extent not otherwise deducted or excluded in computing federal or Ohio adjusted gross income for the taxable year, amounts received by the taxpayer as retired military personnel pay for service in the United States Army,

Navy, Air Force, Coast Guard, or Marine Corps or reserve components thereof, or the national guard, or received by the surviving spouse or former spouse of such a taxpayer under the survivor benefit plan on account of such a taxpayer's death.

[FN312]. S.B. 881, 52nd Legis. Sess., 1st Sess. (Okla. 2009). Oklahoma State Senate Bill 881 passed in May 2009. Active duty military pay is exempt for state tax purposes beginning 1 July 2010.

[FN313]. S.C. CODE ANN. § 12-6-1170 (Westlaw 2010). An individual taxpayer who is the original owner of a qualified retirement account is allowed an annual deduction from South Carolina taxable income of not more than three thousand dollars of retirement income received. Beginning in the year in which the taxpayer reaches age sixty-five, the taxpayer may deduct not more than ten thousand dollars of retirement income that is included in South Carolina taxable income.

[FN314]. UTAH CODE ANN. § 59-10-1019 (Westlaw 2010). Starting in 2008, Utah retirees can no longer exclude retirement income. Retirees sixty-five and over may claim tax credit of $450. Retirees under sixty-five may claim a credit the greater of 6% of retirement income or $288.

[FN315]. VT. STAT. ANN. tit. 32, § 5824 (Westlaw 2010). Vermont follows federal tax rules for retirement pay.

[FN316]. VA. CODE ANN. § 58.1-322 (Westlaw 2010) ("$15,000 of military basic pay for military service personnel on extended active duty for periods in excess of 90 days; however, the subtraction amount shall be reduced dollar-for-dollar by the amount which the taxpayer's military basic pay exceeds $15,000 and shall be reduced to zero if such military basic pay amount is equal to or exceeds $30,000.").

[FN317]. *Id.* Retirees may deduct up to $12,000, depending upon age and amount of income.

[FN318]. W. VA. CODE § 11-21-7 (Westlaw 2010). A servicemember is considered a non-resident for tax purposes if "he maintains no permanent place of abode in [the] state, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in [the] state, or (2) ... is not domiciled in [the] state but maintains a permanent place of abode in [the] state and spends in the aggregate more than one hundred eighty-three days of the taxable year in [the] state." *Id.*

[FN319]. W. VA. CODE § 11-21-12 (Westlaw 2010). The first $20,000 of military retirement pay may be excluded.

APPENDIX F

Army Lawyer
January, 2010

Department of the Army Pamphlet 27-50-440
Administrative and Civil Law Edition
Office of the Judge Advocate General
Legal Assistance Policy Division
OTJAG Practice Note

*106 MILITARY SPOUSES RESIDENCY RELIEF ACT (MSRRA): USE CAUTION AND READ CAREFULLY

Lieutenant Colonel Janet H. Fenton [FNa1]

Opinions and conclusions in articles published in the Army Lawyer are solely those of the authors. They do not necessarily reflect the views of the Judge Advocate General, the Department of the Army, or any other government agency.

On 11 November 2009, President Obama signed the Military Spouses Residency Relief Act (MSRRA) into law. [FN1] The MSRRA amends the Servicemembers Civil Relief Act (SCRA) [FN2] to provide some military spouses the ability to regain a "lost" domicile for tax purposes. As in everything, the devil is in the details.

Much of the news coverage about the MSRRA is misleading. This law does not simply permit a Soldier's spouse to "pick" or "choose" a legal domicile in any state--say, for example, one that does not have income tax. The MSRRA states:

A spouse of a servicemember shall neither lose nor acquire a residence or domicile for purposes of taxation with respect to the person, personal property, or income of the spouse by reason of being absent or present in any tax jurisdiction of the United States solely to be with the servicemember in compliance with the servicemember's military orders if the residence or domicile, as the case may be, is the same for the servicemember and the spouse.

Essentially, the MSRRA allows military spouses to maintain their domicile if they move to accompany their Soldier-spouse due to military orders and the spouse has the same domicile as the Soldier. As used in the SCRA, the terms "residence" and "domicile" are interchangeable. These terms denote the place where a Soldier--and now, the Soldier's spouse--maintains his permanent home and to which the Soldier has the intention to return whenever he is absent. The SCRA, as amended by the MSRRA, now protects Soldiers from owing income taxes on military pay, except in their state of legal residence or domicile, and protects spouses from owing income taxes earned in the state in which they reside solely to be with the Soldier due to military orders, unless the state is also their state of legal residence or domicile. Spouses may not simply pick their domicile to be the same as the Soldier, however. Spouses must meet the requirement of physical presence in the state and show indicia of intent to make the state their permanent home, in order to benefit from the MSRRA's protections.

Domicile is established, not chosen, even though it is no secret that many Soldiers have a propensity to establish domicile in income tax free states, such as Texas, Florida, Washington, Nevada, Alaska, South Dakota, and Wyoming, as well as other tax-favored states, such as New Hampshire and Tennessee. A Soldier must complete DD Form 2058, "State of Legal Residence Certificate," and file the completed form with the personnel office to declare his state of residence or domicile. [FN3] The Defense Finance and Accounting Service (DFAS) uses the DD Form 2058 to determine whether state income tax should be withheld from the Soldier's military pay. However, the DD Form 2058 does not, by itself, legally change the Soldier's domicile.

The DD Form 2058 describes the difference between "home of record" and legal residence or domicile. The instructions explain that residence and domicile are a matter of "physical presence in the new State with the simultaneous intent of making it your permanent home and abandonment of the old State of legal residence/domicile. In most cases, you must actually reside in the new State at the time you form the intent to make it your permanent home. Such intent must be clearly indicated." [FN4]

The following scenarios highlight some of the implications of the MSRRA.

Example 1. Soldier is a resident/domiciliary of Texas. His spouse takes the required steps to establish and maintain residency/domicile in Texas as well. Soldier is then assigned to Virginia, and his spouse moves to Virginia to live with the Soldier. The spouse eventually gets a job in Virginia. The spouse can assert the SCRA, and Virginia cannot tax the spouse's income earned in Virginia.

Example 2. Soldier is a resident/domiciliary of Texas. He is assigned to Virginia, and while in Virginia he meets and marries his spouse, who is working in Virginia. The MSRRA does not permit the spouse to now claim Texas residency/domiciliary. Virginia can tax the spouse's income.

Example 3. Soldier is a resident/domiciliary of Pennsylvania. Her spouse takes the required steps to establish and maintain residency/domicile in Pennsylvania. ***107** Soldier is then assigned to North Carolina, and her spouse moves to North Carolina to live with the Soldier. The spouse eventually gets a job in North Carolina. The spouse can assert SCRA, and North Carolina cannot tax the spouse's income earned in North Carolina; however, Pennsylvania can tax the income. It is incumbent on the spouse to file Pennsylvania estimated taxes on the income and file a Pennsylvania tax return.

States are still sorting out the implications of this law on their income and personal property tax systems. The law is effective for tax year 2009, and state-by-state guidance concerning refunds on 2009 taxes can be found online at individual state tax websites. [FN5] In general, if a military spouse seeks a refund for the income tax withheld by a state, both the Soldier and the spouse should expect some inquiry into their claims of domicile.

Especially in states with large military populations (e.g., Virginia, Maryland, North Carolina, and California,) the initial burden of establishing the bona fides of residence and domicile will fall on the Soldier and spouse. The required indicia of domicile differ from state to state, so Soldiers and their spouses should be careful to check their state's tax form instructions for guidance. Even after a Soldier has demonstrated sufficient evidence to establish residence or domicile in a state, the state may require additional evidence of the spouse's shared domicile with the Soldier. State refunds will often be held pending confirmation of qualification under the MSRRA. Tax refunds may even be delayed in states that allow MSRRA claims to be filed electronically.

In short, legal assistance practitioners should keep the following key points in mind when educating their clients on the MSRRA. First, the MSRRA does *not* create the right to pick and choose any state as a state of residence. Second, the claims of residency of both spouses and Soldiers are likely to be scrutinized carefully by state taxing authorities because the basis for the new SCRA protection is the shared residence or domicile of a Soldier and spouse. Third, unsupportable claims of changed residency may be viewed as fraudulent by state taxing authorities and may subject the family to significant additional tax penalties and interest. Finally, contrary to media reports, neither the SCRA nor the MSRRA exempt Soldiers or spouses who physically reside in a particular state from complying with that state's driver's license requirements.

For more information concerning individual state guidance on these issues, visit the Tax Discussion Board on JAGCNet.

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[FN1]. Pub. L. No. 111-97, 123 Stat. 3007 (2009).

[FN2]. Pub. L. No. 108-189, 117 Stat. 2835 (2003).

[FN3]. U.S. Dep't of Def., DD Form 2058, State of Legal Residence Certificate (Feb. 1977).

[FN4]. *Id.*

[FN5]. *See generally* Federation of Tax Administrators, FTA Links Page, http://www.taxadmin.org/fta/link/ (last visited Jan. 26, 2010) (providing links to individual state tax websites).

CHAPTER E

INTRODUCTION TO FEDERAL INCOME TAXATION

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CAUTION: This document is meant only as an educational outline for training purposes and as a starting point for conducting tax research. Many of the IRS publications and forms were not finalized at the time of the drafting of this document. In addition, numerous potential changes in tax law were being debated. Tax practitioners are highly encouraged to check the IRS website www.irs.gov for the latest publications reflecting the most recent tax legislation which changes constantly.

Outline of Instruction

I. REFERENCES.

A. Applicable IRS Forms and Instructions.

B. Internal Revenue Code (IRC).

C. Treasury Regulations (Treas. Reg.).

D. Home page for the I.R.S. (www.irs.gov)

E. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.
2. Pub. 17, Your Federal Income Tax.
3. Pub. 501, Exemptions, Standard Deduction, and Filing Information
4. Pub. 4012, Volunteer Resource Guide
5. Pub. 4491, Student Training Guide

F. CCH, 2017 U.S. Master Tax Guide (annual).

G. JA 275 Tax Assistance Program Management Guide (2001).

> Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.
>
> Judge Learned Hand
> Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934)

II. FEDERAL INCOME TAX OVERVIEW.

COMPUTATION STEPS

GROSS INCOME

Wages, salaries, tips;	Taxable interest;	Dividends;
State & local tax refunds;	Alimony received;	Business income & losses;
Capital gains & losses;	Other gains & losses	IRA distributions;
Pension & annuities;	Rents & Royalties;	Farm income;
Unemployment compensation	Social security benefits;	Other income

- ADJUSTMENTS

Educator expenses;	Reservists, artists, gov. official expenses;	Health savings account deduction;
Moving Expenses;	IRA deduction;	Student loan interest deduction;
Tuition & fees deduction;	One-half self-employment tax;	SEP, SIMPLE & Qualified Plans;
Self-employed health insurance;	Penalty on early withdrawal of savings;	Alimony paid

= ADJUSTED GROSS INCOME

- DEDUCTIONS

Standard Deduction or
Itemized Deductions

Medical & dental expenses;	State Taxes paid (e.g. Income & Real Estate);	Interest paid;
Charitable contributions;		Job expenses & misc. deductions

- EXEMPTIONS

Taxpayer;	Spouse;	Dependents;

= TAXABLE INCOME

TAX (AMT)

- TAX CREDITS

Foreign tax credit;	Child & dependent care credit;	Credit for elderly or disabled;
Education credits;	Retirement savings contrib. credit;	Child tax credit;
Adoption Credit;	Mortgage interest credit;	Residential energy credit;
General business credit;	Prior year minimum tax credit;	

+ TAXES

Self-employment tax;	Social security & Medicare tax on tip income;	Additional tax on IRAs, etc.;
Household employment taxes;	Health Care	

- PAYMENTS

Federal income tax withheld;	Estimated tax payments;	Earned income credit;
Excess social security tax withheld;	Additional child tax credit;	Amer. Opportunity credit;

= FINAL TAX LIABILITY

III. 2016 NUMEROLOGY (Rev. Proc. 2015-53; inflation adjusted items).

A. There are seven different marginal tax brackets for tax year 2016, and they are 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.

1. Single Individuals (other than Surviving Spouses and Heads of Households):

Taxable Income		Pay	Marginal Tax Rate
Over	*But Not Over*		
$0	$9,275	$0	+ 10% of amount over $0
9,275	37,650	927.50	+ 15% of amount over $9,275
37,650	91,150	5183.75	+ 25% of amount over $37,650
91,150	190,150	18,558.75	+ 28% of amount over $91,150
190,150	413,350	46,278.75	+ 33% of amount over $190,150
413,350	415,050	119,934.75	+ 35% of amount over $413,350
415,050		120,529.75	+ 39.6% of amount over $415,050

2. Married Individuals Filing Joint Returns and Surviving Spouses:

Taxable Income		Pay	Marginal Tax Rate
Over	*But Not Over*		
$0	$18,550	$0	+ 10% of amount over $0
18,550	75,300	1,855.00	+ 15% of amount over $18,550
75,300	151,900	10,367.50	+ 25% of amount over $75,300
151,900	231,450	29,517.50	+ 28% of amount over $151,900
231,450	413,350	51,791.50	+ 33% of amount over $231,450
413,350	466,950	111,818.50	+ 35% of amount over $413,350
466,950		130,578.50	+ 39.6% of amount over $466,950

3. Heads of Households:

Taxable Income		Pay	Marginal Tax Rate
Over	*But Not Over*		
$0	13,250	$0	+ 10% of amount over $0
13,250	50,400	1,325.00	+ 15% of amount over $13,250
50,400	130,150	6,897.50	+ 25% of amount over $50,400
130,150	210,800	26,835.00	+ 28% of amount over $130,150
210,800	413,350	49,417.00	+ 33% of amount over $210,800
413,350	441,000	116,258.50	+ 35% of amount over $413,350
441,000		125,936.00	+ 39.6% of amount over $441,000

4. Married Individuals Filing Separate Returns:

Taxable Income *Over*	*But Not Over*	Pay	Marginal Tax Rate
$0	$9,275	$0	+ 10% of amount over $0
9,275	37,650	927.50	+ 15% of amount over $9,275
37,650	75,950	5,183.75	+ 25% of amount over $37,650
75,950	115,725	14,758.75	+ 28% of amount over $75,950
115,725	206,675	25,895.75	+ 33% of amount over $115,725
206,675	233,475	55,909.25	+ 35% of amount over $206,675
233,475		65,289.25	+39.6% of amount over $233,475

B. 2016 Standard Deduction. (I.R.C. § 63(c)(2) and Rev. Proc. 2015-53)[1]

1. Married filing jointly or qualifying widow(er) – $12,600 ($ for 2017[2]).

2. Single – $6,300 ($ for 2017).

3. Head of household – $9,300 ($ for 2017).

4. Married filing separately – $6,300 ($ for 2017).

C. Reduction of Itemized Deductions. (I.R.C. § 68(b); Rev. Proc. 2015-53) For taxable years beginning in 2016, allowable itemized deductions will be reduced if a taxpayer's AGI exceeds certain threshold levels. Those levels are as follows:

1. Married filing jointly or qualifying widow(er) – $311,300 ($ for 2017).

2. Single – $259,400 ($ for 2017).

3. Head of household – $285,350 ($ for 2017).

4. Married filing separately – $155,650 ($ for 2017).

D. 2016 Personal Exemptions. (I.R.C. § 151(d); Rev. Proc. 2015-53)

1. Personal exemption deduction – $4,050 ($4 for 2017).

2. For taxable years beginning in 2016, the personal exemption phases out for taxpayers with the following adjusted gross income amounts:

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[1] Aged or blind. For taxable years beginning in 2015 and 2016, the additional standard deduction amount under § 63(f) for the aged or the blind is $1,250. The additional standard deduction amount is increased to $1,550 if the individual is also unmarried and not a surviving spouse

[2] See Rev. Proc. 2016- for tax year 2017 adjustments.

Filing Status	AGI Phaseout Begins	AGI Phaseout Ends
Single	$259,400	$381,900
Married Filing Joint Returns and Surviving Spouses	$311,300	$433,800
Heads of Households	$285,350	$407,850
Married Filing Separate	$155,650	$216,900

IV. MILITARY TAX ASSISTANCE.

A. Role of Military Attorneys.

1. Give advice and assistance on Federal, State, and local tax issues.

2. Prepare (simple) returns.

3. Sponsor tax information and training programs.

4. Coordinate use of IRS resources.

5. Administer Tax Assistance Programs.

B. Installation Tax Assistance Services (JA 275).

1. Tax Officer.

2. Legal assistance attorneys.

3. Volunteer tax assistors.

4. Unit tax assistors.

5. Tax Centers and Electronic filing.

V. TAX CLIENT SCREENING.

A. Client Questionnaire/Client Interview.

B. Tax Records and Substantiation.

C. Selecting the proper form.

D. IRS Income Tax Return Processing.

E. Electronic Filing Program.

VI. WHO MUST FILE A RETURN. (I.R.C. § 6012; IRS PUBS 17 & 4012).

A. Whether a taxpayer has to file a tax return depends on (IRS Pub. 17):

1. Gross income.

a. This includes all income not exempt from taxation. (I.R.C. § 61).

b. If a taxpayer is married and the permanent home is in a community property state, then half of any income described by state law as community income may be considered the taxpayer's income.

c. Gross income under this definition includes gain that is excludable on the sale of a residence under I.R.C. § 121 and foreign earned income excludable under I.R.C. § 911. (I.R.C. § 6012(c), Treas. Reg. § 1.6012-

1(a)(3)).

2. Filing status, and

3. Age.

a. Taxpayers over 65 can have a higher amount of gross income than other taxpayers before they must file. (I.R.C. § 6012(A)(1)(b)).

b. Taxpayers are considered 65 on the day before their 65th birthday. (I.R.C. § 22).

B. Generally, an income tax return must be filed by every individual U.S. citizen and resident alien who has gross income that equals or exceeds the following amounts (Treas. Reg. § 1.1-1(b); Treas. Reg. 1.6012-1(a)(1)).

Filing Status	File a Return if Gross Income Exceeds	If 65 or older Gross Income Exceeds
Single	$10,350	$11,900
Married Filing Joint Returns and Surviving Spouses	$20,700	$23,200*
Heads of Households	$13,350	$14,900
Married Filing Separate	$4,050	$4,050
Qualifying Widow(er)	$16,650	$17,900

* Both spouses over 65. If only one spouse is over 65, then $21,950

The filing threshold amount for most individuals is the sum of the individual's exemptions and standard deductions, which would result in no tax due. However, even when the gross income test is not met, a return should be filed whenever a refund of tax or a refundable tax credit (such as the earned income tax credit or the additional child tax credit) is available.

D. The rules apply differently for children or other dependents.

1. The income threshold for filing a tax return is generally lower for an individual who may be claimed as a dependent on another's tax return. If the gross income of the child or dependent was $4,050 or more in 2016, then the child may be claimed as a dependent only by parents, and only if they were either under age 19 or a full-time student under age 24. This income test for dependents will be explained in detail later in the outline.

2. A parent may elect to include on their return the unearned income of a child if the child: is under age 19, or 24 if a full-time student; had no earned income; received unearned income (interest and dividends) in an amount less than $10,500 in 2016 (as indexed for inflation); and made no estimated tax payments. If this election is made, then the child need not file a tax return. (I.R.C. 1(g)(7)(A) and (g)(7)(B)(ii) and IRS Pub 4012).

3. For 2016, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net <u>unearned</u> income reported on the child's return that is subject to the "kiddie tax," is $1,050 ($ for 2017). The same $1,050 amount is used for purposes of § 1(g)(7) (that is, in determining whether a parent may elect to include a child's gross income in the parent's gross income and for calculating the "kiddie tax"). For example, one of the requirements for the parental election is that a child's gross income is more than the amount referenced in § 1(g)(4)(A)(ii)(I) but less than 10 times such amount; thus, a child's gross income for 2016 must be more than $1,050 but less than $10,500 to satisfy that requirement.

4. A child or dependent must file a return if their unearned income is more than $1,050 in 2016 or their total gross income is more than the standard deduction ($6,300 for 2016) (I.R.C. § 6012(a)(1)(C)(i)).

E. An individual who has $400 or more of net earnings from self-employment must file an income tax return even though his gross income is less than the required amount (I.R.C. § 6017).

F. Every individual who has received advance payments of earned income credit (EIC) from his employer must file a return regardless of the amount of his income (I.R.C. § 6012(a)(8)).

G. Other individuals that may have to file an income tax return even though they have gross income below the levels listed above:

1. Individuals who received tips from which no social security tax was withheld. (IRS Pub. 17).

2. Nonresident alien individuals. (Treas. Reg. § 1.6012-1(b)910(i)).

3. Individuals who must pay tax with respect to an IRA or qualified retirement plan.

4. Liability for alternative minimum tax is incurred.

5. Tax is due on the recapture of various credits, for example the first-time homebuyers credit. (If you received the $7,500 first-time homebuyer credit for the purchase of a home in 2008, starting in 2010 you had to begin repaying the credit by adding $500 each year to your tax bill – for 15 years.)

H. Filing a tax return for a deceased person. (I.R.C. § 6012).

1. A final income tax return must be filed for a deceased person who would be required to file, if alive, for the part of the year up to the date of death. (I.R.C. § 6012(b)(1)).

2. Filing requirements.

   a. A return on behalf of a decedent must be filed if gross income amounts exceed the threshold amounts discussed above. Write "DECEASED" and the date of death across the top of page 1 of the return.

   b. A return should also be filed to obtain a refund. In certain circumstances, Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, should be filed.

3. The executor, personal representative, administrator, or other legal representative is responsible for filing the tax return. If an executor or personal representative has not been appointed, the surviving spouse may file the joint return. (I.R.C. § 6012(b)(1)).

VII. TAX RETURN PREPARATION.

A. Enter name and address.

1. Name(s) must match that on the Social Security card.

2. Address.

a. If the IRS does not have a current address, the payment of a refund may be delayed.

b. If the taxpayer owes taxes, the IRS may enforce a deficiency notice sent to the address on the most recently filed tax return, even if the taxpayer never receives the IRS notice.

c. To avoid problems, the taxpayer should file a Form 8822 with the IRS to provide notice of an address change.

d. For purposes of mailing official IRS notices, a taxpayer's "last known address" is the address on the most recently filed tax return, unless the IRS is given clear and concise notification of a different address. (I.R.C. § 6212(b); *Abeles v. Commissioner*, 91 T.C. 1019 (1988).

B. Social Security Number.

C. Presidential Election Campaign Fund.

1. The funds help pay for Presidential election campaigns. If the taxpayer wants $3 to go to this fund, check the "Yes" box. If filing a joint return, the spouse may also have $3 to the fund.

2. Checking "Yes" will not decrease the amount of a refund or add to an amount due.

VIII. WHEN TO FILE.

A. Returns due 15 April (Treas. Reg. § 1.6072-1(a)) (unless the 15th falls on a weekend/holiday). For 2016 tax returns will be due April 17, 2017 (April 15 falls on a Saturday; note that Emancipation Day is observed on Monday, April 18, 2017, in Washigton, D.C.).

B. "Automatic Extension" (Treas. Reg. § 1.6081-4(a)).

1. Automatic 6-month extension is available to file an individual income tax return (October 16 – same for taxpayers outside the U.S.). Request an extension by filing Form 4868 by the due date (normally April 17).

2. An extension to file is not an extension of time to pay (Treas. Reg. § 1.6081-4(b)).

3. Interest charges apply to any tax not paid by the due date (normally April 15). The rate of interest on tax underpayments is the Federal short-term rate plus three percentage points. (Code Sec. 6621(a)(2)). The annual interest rate is subject to change each calendar quarter. (I.R.C. § 6601(b)(1); Treas. Reg. § 301.6601-1(a))

4. Underpayment Penalty. Taxpayer is liable for late penalty of 0.5 percent per month if the total amount paid by the due date (normally April 15) is less than 90% of the actual tax payable.

5. Form 4868 can be filed electronically or by telephone. The procedure is described in Publication 1345, Handbook for Electronic Filers of Individual Tax Returns.

a. The electronic Form 4868 should be transmitted to the IRS Service Center where the return will be filed.

b. The IRS Service Center will acknowledge receipt of the extension.

c. If a payment is due with an electronically filed extension, then the taxpayer is required to submit a check to the lockbox address listed on

the reverse side of the Form 1040-V, Payment Voucher. The check should contain the taxpayer's name, social security number, tax period and a description relating to the Form 4868. The extension is not sent with the payment.

d. An electronically extended return may be filed in paper form, if desired. It is not necessary to file the tax return merely because it was electronically extended.

6. If a taxpayer files a Form 4868 and the IRS determines that the taxpayer did not make a reasonable effort to determine his/her tax liability, then the IRS can deny the extension retroactive to the due date.

7. CAUTION: If the taxpayer owes money and files a Form 4868 with no payment, the IRS can deny the extension and assess the taxpayer with a late filing penalty (5% per month) on the tax owed. The IRS could also asses a failure to pay penalty of 0.5% per month PLUS interest.

8. An individual filing a Form 4868 is not a clear and concise notification to the IRS of a taxpayer's change of address. If the IRS mails a deficiency notice to the address on a prior year tax return (last known address), then the IRS is not obligated to regard or record the address shown on the Form 4868 as the taxpayer's current address. (I.R.C. § 6213; Stroupe v. Commissioner, T.C. Memo 1998-380; 1998 Tax Ct. Memo LEXIS 383,*; 76 T.C.M. (CCH) 713; T.C.M. (RIA) 98380).

C. Overseas Extension (Treas. Reg. § 1.6081-5(a)(6)). Military personnel on duty outside U.S. or Puerto Rico on April 15 are allowed an automatic extension of two months, until June 15, to file and pay tax (however, see below).

1. If taxpayer files a joint return, then only one spouse has to qualify for this automatic extension.

2. Attach a statement to the return explaining what situation qualified the taxpayer for the extension.

3. If a taxpayer uses the overseas extension and waits to pay any taxes due, they will be charged interest from the regular filing date.

4. Attempts to legislatively fix this problem for the military (Uniform Filing Fairness Act) failed to be enacted.

D. Return is filed on time if it is properly addressed and postmarked by the due date.

If return is sent by registered mail, then the date of the registration is the postmarked date. If return is sent by certified mail, then the date on the receipt postmarked by the postal employee is evidence the return was delivered.

E. The IRS recognizes and accepts several private delivery services (e.g., FedEx and UPS).

IX. COMBAT ZONE OR QUALIFIED HAZARDOUS DUTY AREA

A. What is a Combat Zone (CZ) or Qualified Hazardous Duty Area (QHDA)?

1. Combat Zone (CZ).

a. A CZ is an area that the President of the United States has designated by Executive Order in which the Armed Forces are or have engaged in combat. I.R.C. § 112(c)(2).

b. Service members may invoke CZ tax relief only if they serve in a CZ on or after the date designated in the Executive Order.

2. Qualified Hazardous Duty Area (QHDA).

a. Legislation creates a "qualified hazardous duty area." The legislation will specify the date that members in the QHDA become eligible for tax relief.

b. Members serving in a QHDA receive the same tax treatment under the Internal Revenue Code as members serving in a CZ. P.L. 104-117, § 1(a)(2), (b), (e)(1), 109 Stat. 827 (1996).

c. In the two QHDAs created by Congress, Congress has designated certain countries as QHDAs and has specified that each designated country will lose its status as a QHDA when the Department of Defense stops paying members either imminent danger or hostile fire pay for service in that country. In addition, Congress could also enact legislation terminating the QHDA.

B. How Does a Service Member Qualify for Service in a CZ or QHDA?

1. The service must be performed on or after the date of designation in the Executive Order issued by the President as the commencement date (or in the legislation in the case of the QHDA) and on or before the termination date in the Executive Order (or the date that members in that country stop receiving imminent danger/hostile fire pay in the case of the QHDA). I.R.C. § 112(c)(3).

2. Generally, to receive CZ tax benefits, a member must serve in a CZ or QHDA.

3. Service members outside of a CZ or QHDA receive CZ tax benefits when their service directly (as opposed to remotely or indirectly) supports military operations in the CZ upon the meeting of two basic conditions.

a. First, the direct support of military operations has to have the effect of maintaining, upholding, or providing assistance for those involved in military operations in the CZ (or QHDA). Treas. Reg. § 1.112-1.

b. Second, the service must qualify the service member for hostile fire pay or imminent danger pay. Treas. Reg. § 1.112-1.

C. Extension of Time for Tax Actions.

1. Soldiers qualifying for service in a designated CZ or QHDA, or when deployed outside the United States away from the individual's permanent duty station while participating in an operation designated by the Secretary of Defense as a contingency operation, are entitled to special extensions of time for completing various tax actions. The suspension of time applies to the following acts pursuant to I.R.C. § 7508(a)(1):

a. Filing any return of income, estate, or gift tax (except employment and withholding tax);

b. Payment of any income, estate, or gift tax (except employment and withholding tax) or any installment thereof or of any other liability to the United States in respect thereof;

c. Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

d. Allowance of a credit or refund of any tax;

e. Filing a claim for credit or refund of any tax;

f. Bringing suit upon any such claim for credit or refund;

g. Assessment of any tax;

h. Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

i. Collection, of the amount of any liability in respect of any tax;

j. Bringing suit by the United States, or any officer on its behalf, in respect of any liability in respect of any tax; and

k. Any other act required or permitted under the internal revenue laws specified in regulations prescribed under this section by the Secretary;

2. The deadline extension also applies to the filing of all tax schedules and forms that are attachments to the federal individual tax return.

3. Spouses of service members entitled to the CZ tax benefits are entitled to the

same suspension of time for handling tax matters. I.R.C. § 7508(c).

4. The suspension of time encompasses the period of service in the CZ, as well as any time of continuous qualified hospitalization resulting from injury received in the CZ and the next 180 days thereafter. I.R.C. § 7508(a).

5. The additional time is disregarded in determining tax liability under the Internal Revenue Code (including interest, penalty, additional amount, or addition to tax). I.R.C. § 7508(a).

6. The IRS has determined that this extension runs consecutively, not concurrently, with the tax-filing season (tax filing season = 1 Jan. to 15 Apr.).

   a. Consequently, Soldiers serving in a CZ may be entitled to up to 105 additional days for a total CZ extension of 285 days to complete action on tax matters after leaving the CZ.

   b. For example, a Soldier serving in the CZ from 1 October 2013 until 1 May 2014 will have the full 285 days to file the 2013 tax return. This extension equals the 180-day extension, plus the full 105 days in the tax-filing season. However, a Soldier arriving in the CZ on 1 February 2013 and serving until 1 February 2014 will have 254 days. This period of time is equivalent to the full 180-day extension, plus the 74 days remaining in the filing season from 1 February 2014. See I.R.S. Notice 99-30, 1999-22 I.R.B. 1.

7. The CZ extensions also apply to individuals serving in the CZ in support of the U.S. Armed Forces. These include Red Cross personnel, accredited correspondents, and civilians acting under the direction of the U.S. Armed Forces in support of those forces (both Department of Defense civilian employees and civilian employees of defense contractors). I.R.S. Notice 99-30, 1999-22 I.R.B. 1, Q & A #13.

D. Current CZs and QHDAs.

1. Operation Desert Storm (Arabian Peninsula / Persian Gulf Areas) CZ.

a. President Bush signed an Executive Order on January 21, 1991, designating the Persian Gulf Area as a CZ. Exec. Order No. 12744, reprinted in, 56 Fed. Reg. 2661 (Jan. 23, 1991). The CZ designation is still open and will remain open until terminated by another Executive Order.[3] Service members serving in the Persian Gulf CZ are still eligible for the previously mentioned benefits.

b. The Executive Order designated the following locations within the CZ: the Persian Gulf; the Red Sea; the Gulf of Oman; the Gulf of Arden; that portion of the Arabian Sea that lies north of 10 degrees north latitude and west of 68 degrees east longitude; and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

c. Service members serving outside of the CZ in direct support of the military operations within the Persian Gulf CZ under conditions which they are entitled to hostile fire pay are entitled to the CZ tax benefits.

2. QHDA of Bosnia, Herzegovina, Croatia and Macedonia (Operation Joint Forge) QHDA designation ended 1 November 2007.

a. Tax relief was legislatively extended to service members in the QHDA of Bosnia, Herzegovina, Croatia, or Macedonia if they are serving in those areas and receiving hostile fire or imminent danger pay. P.L. 104-117, § 1(a)(2), (b) and (e)(1), 109 Stat. 827 (1996).

(1) These areas were specifically designated as a QHDA and result in service members receiving all the federal tax benefits of a CZ as if it was designated by Executive Order by the President. All of the CZ tax benefits previously mentioned apply to this QHDA.

(2) Service members assigned outside of the QHDA in direct support of the military operations within this designated QHDA under conditions which they are not entitled to hostile fire pay are entitled to very limited CZ tax benefits. Service members who are performing services as part of the operation outside of the United States while deployed away from their permanent duty stations in support of the QHDA are allowed

[3] See http://www.archives.gov/federal-register/executive-orders/1991.html

an extension of time allowed for performing most acts required by the Internal Revenue Code. I.R.C. § 7508. This was the only CZ tax provision extended to these individuals. P.L. 104-117, § 1(a)(2), (b) and (e)(1), 109 Stat. 827 (1996).

b. On 20 June 1998, Operation Joint Guard was terminated and Operation Joint Forge commenced. Operation Joint Forge is a follow-on operation to Operation Joint Guard, which was a follow- on operation to Operation Joint Endeavor.

c. Service members serving in the geographic area of this QHDA are not affected by a change of the name of the operation. The IRS has stated that personnel serving under Operation Joint Forge will be treated that same as personnel serving under Operation Joint Endeavor since Operation Joint Forge is the substantive continuation of Operation Joint Endeavor. See, Letter from Tommy G. Deweese, District Director for the International District, Internal Revenue Service, to Lieutenant Colonel Thomas K. Emswiler, Armed Forces Tax Council, Department of Defense (17 July 1998), cited in footnote 6, Joint Committee on Taxation, (JCX-17-99) (Apr. 12, 1999), a description of present law and a proposal relating to tax relief for personnel in the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Northern Ionian Sea. Also see Information Paper, Office of the Judge Advocate General, U.S. Army, DAJA-LA, subject: Operation Joint Forge Tax Treatment (15 Sep 1999); and Major Mark Henderson, Tax Law Note, Bosnian Tax Relief, ARMY LAW., May 1996 at 27.

3. Operation Allied Force CZ (Kosovo Area – Federal Republic of Yugoslavia (Serbia/Montenegro), and Albania).

a. On April 13, 1999, President Clinton issued an Executive Order designating a CZ for the area of the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Ionian Sea north of the 39th parallel, including the airspace above the locations. Exec. Order No. 13,119, 64 Fed. Reg. 18797 (April 16, 1999); IR-1999-43. The Executive Order designated March 24, 1999 as the date of commencement of activities in the CZ.

b. Service members serving outside of the CZ in direct support of the military operations within the Operation Allied Force Combat Zone

under conditions which entitled them to hostile fire pay are entitled to the CZ tax benefits.

c. The CZ designation is still open, and has not been terminated by another Executive Order. Service members serving in the Operation Allied Force CZ are still eligible for the previously described benefits.

4. Operation Allied Force QHDA (Federal Republic of Yugoslavia (Serbia/Montenegro), and Albania)

a. President Clinton signed legislation designating a QHDA on April 19, 1999, for the area of:

(1) The Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, the northern Ionian Sea above the 39th parallel during the period that a service member is entitled to hostile fire or imminent danger pay for service performed in the designated area. The Act is generally effective as of March 24, 1999. P.L. 106-21, 113 Stat. 34 (1999).

(2) The areas mentioned were specifically designated as a QHDA and result in service member's entitlement to all the tax benefits of a CZ as if it was designated by Executive Order by the President. All of the CZ tax benefits apply to the specified geographic locations of the QHDA.

(3) Service members serving outside of the CZ in direct support of the military operations within this designated QHDA under conditions for which they are not granted hostile fire pay are entitled to very limited CZ tax benefits. Service members who are performing services as part of the operation outside of the United States while deployed away from their permanent duty stations in support of the QHDA are allowed an extension of time allowed for performing most acts required by the Internal Revenue Code. I.R.C. § 7508. This was the only CZ tax provision extended to these individuals. P.L. 106-21, 113 Stat. 34 (1999).

b. The area of operations for Operation Allied Force has been designated as both a CZ by Executive Order and a QHDA by specific legislation.

(1) Generally, the two provide the same tax benefits. The QHDA provides that service members performing services outside of the areas, but still a part of Operation Allied Force, would qualify for the suspension of time to perform various tax acts (I.R.C. § 7508) during the periods in which they are not paid hostile fire or imminent danger pay. But the services must be performed both outside the United States and while deployed away from the service member's permanent duty station. P.L. 106-21, 113 Stat. 34 (1999); Joint Committee on Taxation, (JCX-17-99) (Apr. 12, 1999).

(2) The CZ designation for Operation Allied Force will remain open until terminated by another Executive Order. Likewise, the QHDA will remain in effect until terminated by Congress or the IRS determines that any future follow- on operation is not a substantive continuation of the QHDA.

(3) Although the Operation Allied Force area of operations is commonly referred to as the Operation Allied Force CZ, Judge Advocates must not forget that the area has been designated a CZ and a QHDA. In the event one of the designations is terminated in the future, relief may still be available under the rules of the other designation.

5. Afghanistan (Operation Enduring Freedom)

a. Afghanistan and the air space above it have been designated as a combat zone. Executive Order 13239, signed on 14 December 2001, by President George Bush.

b. The designation is retroactive to 19 September 2001.

c. Pursuant to Treasury Regulation §1.112-1 and Revenue Ruling 70-621, 1970-2C.B. 17, all military personnel in Uzbekistan, Kyrgystan, Pakistan, Tajikistan, and Jordan are eligible for all combat zone related

tax benefits due to their service in direct support of military operations in the Afghanistan combat zone, as designated by executive order. The effective date of this certification is September 19, 2001, for Pakistan, Tajikistan, and Jordan and October 1, 2001, for Kyrgystan and Uzbekistan (because troops in Kyrgystan and Uzbekistan were not eligible for imminent danger pay in September).

d. Current areas that qualify for combat zone tax exclusion in support of Operation Enduring Freedom:

(1) Pakistan, Tajikistan and Jordan from 19 September 2001;

(2) Uzbekistan and Kyrgyzstan from 1 October 2001;

(3) The Philippines from 9 January 2002 (Only troops with orders referencing Operation Enduring Freedom.);

(4) Yemen from 10 April 2002;

(5) Djibouti from 1 July 2002; and

(6) Somalia from 1 January 2004.

E. Operation Iraqi Freedom. (IRS Notice 2003-21, 2003-17 IRB, 04/10/2003)

1. IRS Notice 2003-21 provides guidance in a question and answer format on the tax relief provided under Executive Order No. 12744, 56 Fed. Reg. 2663 (Jan. 23, 1991), for U.S. military and support personnel involved in the military operations in the "Arabian Peninsula Areas."

2. Please note the relevant executive order. Operation Iraqi Freedom neither creates, nor required the creation of, new law relevant to taxes and combat zones. This area is still covered by the Operation Desert Storm executive order.

3. The termination of imminent danger pay also terminates combat zone related tax benefits. The following are the periods for "in direct support" areas for Operation Iraqi Freedom (Arabian Peninsula Areas combat zone):

a. Turkey from 1 January 2003 to 31 December 2005;

b. Israel from 1 January 2003 to 31 July 2003;

c. The Mediterranean Sea east of 30 degrees East longitude (sea area only) as an imminent danger area effective 19 March 2003 to 31 July 2003;

d. Jordan from 19 March 2003; and

e. Egypt from 19 March 2003 through 20 April 2003.

F. Filing Tax Returns for CZ Participants

1. Service members who qualify for extensions of time to file federal tax returns pursuant to the CZ extensions can file their returns in accordance with the filing extensions previously mentioned. In addition, the service member can elect to file their return before the end of the extension period.

2. Service members in a CZ can authorize someone else to file their taxes in their absence by executing a special power of attorney, a general power of attorney, or the IRS Form 2848 (Power of Attorney and Declaration of Representative). When someone will act on behalf of a service member to file a tax return using a power of attorney, the form, or a copy of the power of attorney must be attached to the tax return.

3. Service members using a CZ or QHDA extension to file any type of tax form should write the name of the CZ or QHDA at the top of any tax return, reply notice, or other correspondence sent by the IRS (i.e., "Operation Desert Storm Combat Zone," "Operation Joint Forge Combat Zone," "Operation Allied Force Combat Zone"). IRB-1999-43.

4. There are many resources available to Judge Advocates to use as preventive law handouts to service members on how to "invoke" the CZ extensions and properly notify the I.R.S. (and other taxing authorities) of the CZ application. See, Tax Relief for those Affected by Operation Allied Force, Internal Revenue Bulletin 1999-22 IRB 1; Notice 99-30, a copy of which can be found

at, I.R.S. Publication 3, Armed Forces Tax Guide.

G. State Taxation Implications of CZ Designations.

1. Generally, most states follow the federal government's lead in granting tax relief for service members in a CZ or QHDA. However, the manner in which the various states reach that determination, the amount of exclusion, and the amount of time extended to handle tax matters and file tax returns varies from state to state.

   a. Some states have enacted legislation, which in effect adopts the applicable sections of the federal Internal Revenue Code dealing with CZ extensions, exclusions and other benefits. Other states enact specific legislation dealing with each CZ or a QHDA designation.

   b. The states are very diverse in the treatment of penalties and interest. Some states —waive penalties and interest during the combat zone extension period. Other states "abate" or "forgive" penalties and interest during the combat zone extension period. A few states simply state in policy guidance that service members will not be charged interest and penalties during the CZ extension period. Some states simply do not provide explicit guidance regarding the treatment of interest and penalties.

2. While most states follow the lead of the federal government in providing CZ tax relief, the Judge Advocate should avoid providing general tax advice that "all states follow the federal government CZ tax rules." The advice could lead to false assumptions that are contrary to applicable state laws. Judge Advocates should also be aware of the legal basis for a state's CZ tax rules (based upon state's statutes, administrative codes, and policy guidance) before providing tax advice to service members regarding individual state CZ tax rules.

3. An article appears in the December 1999 Army Lawyer, at page 1, entitled Update: Tax Benefits for Military Personnel in a Combat Zone or Qualified Hazardous Duty Area, by Major Richard W. Rousseau, which summarizes state CZ tax rules.

4. The Air Force prepares a "Deployment Tax Guide" accessible via the FLITE

system. It provides information on each state's rules and practices in this area.

X. FILING STATUS (FORM 1040, LINE 1-5).

A. Single Taxpayers.

1. Defined.

a. Anyone who is not married. This is the default status where an unmarried individual does not qualify to file their returns as a married individual, as a surviving spouse, or as head of household.

b. Taxpayers are considered unmarried for the whole tax year if either of the following applies: (I.R.C. § 7703).

(1) There is a final decree of divorce or separate maintenance by the last day of the tax year. State law will control to determine whether a taxpayer is divorced or legally separated.

(2) There is a decree of annulment, which holds that no valid marriage ever existed.

c. Anyone who is married, but is separated pursuant to a decree of separate maintenance. Taxpayer is considered married for the whole tax year if there is no final decree of divorce or separate maintenance by the last day of the tax year. An interlocutory decree is not a final decree.

(1) According to the Tax Court, an individual is considered legally separated under a decree if the decree "expressly and affirmatively provides that the parties live apart in the future." (Capodanno v. Commissioner, 69 T.C. 638 (1978), aff'd, 602 F. 2d 64 (3d Cir. 1978).

(2) A voluntary separation under a voluntary separation

agreement does not constitute legal separation for purposes of I.R.C. § 7703(a)(2). (See, e.g., Kellner v. Commissioner, 468 F.2d 627 (2d Cir. 1972), aff'g per curiam T.C. Memo 1971-103; Johnson v. Commissioner, T.C. Memo 1980-9).

d. The "Abandoned Spouse Rule." (I.R.C. § 7703(b)). A married but separated spouse who is not "legally separated" within the meaning of I.R.C. § 7703(a)(2) may nevertheless be treated as unmarried under the "abandoned spouse rule." A married individual shall not be treated as married if the taxpayer:

(1) Files a separate return from the spouse;

(2) Maintains a home that is the principal place of abode of a child, (within the meaning of section 152(f)(1)), which is a son, daughter, stepson, or stepdaughter or an eligible foster child) with respect to whom the taxpayer is entitled to a deduction for the taxable year under section 151 (or would be so entitled but for section 152(e));

(a) A taxpayer maintains a home or household if he or she actually occupies it and it is the principal residence of the child for the period he or she actually lives there. (Treas. Reg. § 1.143-1(b)(3); Treas. Reg. § 1.2-2(c)(1)).

(b) Temporary absences from the household by the "qualifying person" due to illness, education, business, vacation, military service and visitation with the noncustodial parent will not interrupt the period of occupancy if under circumstances it is reasonable to assume the child will return to the household. (Treas. Reg. § 1.2-1(c)(1); Treas. Reg. § 1.143-1(b)(3); Blair v. Commissioner, 63 T.C. 214 (1974)).

(3) Furnishes over one-half of the cost of maintaining such household during the tax year; and

(a) Qualifying "costs of maintaining a household" are expenses incurred for "the mutual benefit of the occupants thereof by reason of its operation as the principal abode of such occupants." (Treas. Reg. § 1.2-2(d); Treas. Reg. § 1.143-1(b)(4)).

(b) Such expenses include property taxes, mortgage interest, rent, utilities, maintenance and repair expenses, casualty insurance, and food consumed on the premises.

(c) The following expenditures do not constitute the costs of maintaining a household: clothing, education, health, vacations and support costs.

(4) Such taxpayer's spouse is not a member of such household during the last six months of the year.

(a) "Not a member of the same household" requires living in separate residences for the last six months of the year of the tax year.

(b) The spouse is considered to live with the taxpayer if he or she was temporarily absent due to special circumstances such as illness, education, business, vacation, and military service.

(c) The Tax Court denied a head of household status to a wife who had moved out of the marital home in August after she was unable to evict her husband. The couple decided to terminate their marriage in June, but because the husband had been unable to find housing, he sometimes slept in her living room. The Tax Court stated that "living apart" requires geographical separation and means living in separate residences. (Hopkins v. Commissioner, T.C. Memo 1992-326).

(d) It made no difference where the stay beyond the sixth month period was outside the taxpayer's control. (Nemeth v. Commissioner, T.C. Memo. 1982-646).

(e) The taxpayer did not satisfy this requirement where the spouses maintained separate bedrooms and bathrooms. Lyddan v. Commissioner, 721 F.2d 873 (1983).

(f) Taxpayer unsuccessfully argued that he did not live with his wife, even though they resided in the same home, because they were emotionally estranged and did not share the same bedroom. The Tax Court concluded that the notion of "living apart" means "living in separate residences" and requires "geographic separation." Chiosie v. Commissioner, T.C. Memo. 2000-117.

2. Single return (Form 1040, Line 1).

3. Head of Household (Form 1040, Line 4; I.R.C. § 2(b)).

a. Advantages of Head of Household Status:

(1) Tax rates lower for head of household than those for filing single.

(2) Standard deduction is higher than is allowed on a single or married filing separate return.

(3) For a married person who lived apart from his or her spouse during the last half of the tax year, then qualifying as a head of household allows the use of tax rates that are more favorable than those for married persons filing separately.

(4) May be able to claim credits, such as child care credit (I.R.C. § 21(e)(2)) and earned income credit, the taxpayer could not

claim on a married filing separate return.

b. To qualify as a head of household, the taxpayer must:

(1) Be a U.S. citizen or resident throughout the year, and

(2) Unmarried or considered unmarried at the close of the year ("Abandoned Spouse Rule"), and

(3) Paid more than half the cost of keeping up (maintaining) a home for the year, and

(4) One of the following was a member of the household for more the half of the year:

(a) A qualifying child of the individual (as defined in I.R.C. § 152(c) (child, brother, sister, stepbrother, or stepsister under the age of 19 or a student under the age of 24, determined without regard to I.R.C. § 152(e) – divorced parents), but not if such child is married at the close of the taxpayer's taxable year, and is not a dependent of such individual by reason of I.R.C. § 152(b)(2) or 152(b)(3) (married or noncitizen), or both, or

(b) any other person who is a dependent (must not provide more than one-half of their own support for the year) of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such person under I.R.C. § 151; or

(c) maintains a household which constitutes for such taxable year the principal place of abode of the father or mother of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such father or mother under I.R.C. § 151.

(5) The taxpayer must be able to claim an exemption for the qualifying person. However, this test can still be met if the taxpayer does not claim the exemption only because the noncustodial parent is allowed to claim the exemption for the child (discussed later).

(6) A parent does not have to have custody of a child to be eligible for head of household filing status. However, the actual time a child spends at a parent's home is used to determine whether the residence constitutes the child's principal residence for over half the tax year.

B. Married Taxpayers.

1. Taxpayer is considered married for tax purposes if married on 31 December. (I.R.C. § 7703(a)(1)) (Unless he qualifies to be treated as "unmarried" – see "Abandoned Spouse" rule, I.R.C. § 7703(b)).

2. If the taxpayer lives together in a common law marriage that is recognized by the law of the state in which the taxpayer lives, or the state where the marriage began, then the taxpayer will be treated as married.

3. Same-Sex Marriage

a. Beginning in 2013, same-sex couples legally married in a jurisdiction, even if they do not currently reside in a jurisdiction that recognizes same-sex marriage, will be treated as married for federal filing purposes. (Rev. Rule 2013-17; IRS Notice 2013-61)

b. Legally married same-sex couples must file a tax return using either the married filing jointly or the married filing separate filing status.

c. This rule only applies to a legally married same-sex couples and does not apply to registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law.

4. If a spouse dies during the tax year, the surviving spouse is treated as married for that entire year and may file a joint return.

5. Filing choices for married taxpayers.

   a. Joint return (Form 1040, Line 2; I.R.C. § 6013).

   b. Married filing separately (Form 1040, Line 3; I.R.C. § 6012).

6. Nonresident alien spouse election. A taxpayer who is a U.S. resident or citizen may file a joint return with a nonresident alien spouse if both agree to be taxed on their world-wide income (see IRS Pub. 519).

7. Joint return (I.R.C. § 6013).

   a. There is no longer a disadvantage in tax rates or standard deductions between married filing jointly and married filing separately.

   b. On a married filing joint return, both spouses include all income, exemptions, and deductions.

   c. Disadvantage to a joint return:

      (1) Both spouses are responsible, jointly and individually, for tax and any interest and/or penalty due on a joint return.

         (a) The significance of joint and several liability cannot be overstated. The decision by parties contemplating a divorce to file a joint return must be made in recognition of this fact.

         (b) If a deficiency of tax is assessed with respect to a joint return and the taxpayers no longer reside in the same household or are no longer married, then, upon the written request of either taxpayer, the IRS must

disclose whether it has attempted to collect the deficiency from the other taxpayer, the general nature of the collection activities, and the amount collected. (I.R.C. § 6013(d)(3)).

(2) Exceptions for "Innocent Spouses" I.R.C. § 6015; Injured Spouse, IRC § 6402.

d. Practical Problems: signing returns and allocation of refunds.

8. Not filing a joint return may result in higher taxes.

a. Married taxpayers cannot claim credit for child and dependent care unless a joint return is filed, i.e., not allowed for married filing separate (I.R.C. § 21(e)(2)).

b. Married taxpayers cannot take earned income credit unless a joint return is filed (I.R.C. § 32(d)).

c. Married taxpayers cannot claim the American Opportunity, Hope Scholarship or the Lifetime Learning credits unless a joint return is filed (I.R.C. § 25A(g)(6)).

d. Married taxpayers cannot deduct student loan interest unless a joint return is filed (I.R.C. § 221(f)(2)).

e. Married taxpayers cannot roll over a Traditional IRA to a Roth IRA unless a joint return is filed (I.R.C. § 408A(c)(3)(B)(ii)).

f. Married taxpayers cannot take the credit for adoption expenses in most instances if filing a separate return (I.R.C. § 23(f)(i)).

g. Married taxpayers filing separate returns cannot exclude the interest from qualified savings bonds used for higher education expenses (I.R.C. § 135(d)(3)).

h. The AGI threshold amounts for married taxpayers filing separate returns for the limit on the child tax credit (I.R.C. § 24(B)(2)(b)), itemized deductions (I.R.C. § 68(b)(1)), and the phaseout of the deduction for personal exemptions (I.R.C. § 151(d)(3)(C)(iv), are reached at income levels that are half of those for a joint return.

9. Married filing separately (I.R.C. § 6012).

a. If married individuals do not file a joint return and neither of them qualifies as unmarried under I.R.C. § 7703(b), then they must each file a separate return using the married filing separately rates.

b. Each spouse reports own income, exemptions, and credits. Each spouse is responsible only for the tax due on his or her own return.

c. Separate returns may save taxes where filing separately allows the taxpayer to claim more deductions. On separate returns, larger amounts of medical expenses, casualty losses, or miscellaneous deductions may be deductible because lower adjusted gross income floors apply.

d. If one spouse itemizes, then both must itemize (not allowed to take the standard deduction if the other spouse itemizes).

(1) A married person filing a separate return cannot claim the standard deduction if his or her spouse files as head of household and elects to itemize deductions.

(2) However, if a married person filing a separate return itemizes, then the other spouse can claim the standard deduction if filing as head of household.

(3) See, Significant Service Center Advice, CCA 200030023, Memorandum for Kenneth J. Rubin, Assistant District Counsel Pennsylvania District Counsel, from Lewis J. Fernandez by George Baker, Deputy Assistant Chief Counsel (27 Jun 00). A copy of the memorandum can be found at Tax

Notes Today, 2000 TNT 147-42, July 31, 2000.

e. Taxpayers in community property states (that is, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, & Wisconsin):

(1) May report one-half of community income on separate returns.

(2) Generally report their own income if living apart and file separate returns (I.R.C. § 66a; IRS Pub. 555, Community Property and the Federal Income Tax).

(3) Cannot electronically file a married filing separately tax return.

C. Qualifying Widow(er) with dependent child (Form 1040, Line 5; I.R.C. § 2(a)). Special filing status for surviving spouse with dependent if deceased spouse died within two preceding years.

a. A surviving spouse (qualifying widow(er)) whose spouse died during either of the surviving spouse's two tax years immediately preceding tax year is taxed at joint return rates if the surviving spouse:

(1) Has not remarried at any time before the close of the tax year (I.R.C. § 2(a)(2)(A)),

(2) Maintains a household as his or her home that is the principal place of abode of a child,

(3) Is entitled to a dependency exemption for at least one child, stepchild, adopted child, or foster child (I.R.C. § 2(a)(1)), and

(4) Was entitled to file a joint return with the deceased spouse for the year of death (I.R.C. § 2 (a)(2)(B)).

b. Spouses of individuals in “missing in action” status as a result of “combat zone” or “qualified hazardous duty area” service can use different rules. When an MIA or POW is officially determined to be dead and is removed from the missing status rolls, then the surviving spouse status does not depend on the actual date of death. The relevant date is the date of official determination, or, if earlier, two years after the date of official termination of combat activities in that zone. If a later actual death is established, then that date will control (I.R.C. § 2(a)(3)).

D. IRS Individual Income Tax Return Filing Status.

1. Check the appropriate block on Form 1040, Lines 1-5.

2. Form preparation points to remember:

a. Married filing separately must specifically list the spouse’s name and social security number of the spouse on line 3.

b. Qualifying widow with dependent child must list the year the spouse died by block 5.

XI. EXEMPTIONS (I.R.C. § 151, FORM 1040, LINES 6a-d).

A. An individual may claim a personal exemption deduction and an exemption deduction for each person he/she claims as a dependent on their income tax return. The exemption amount is $4,050 for 2016. (I.R.C. § 151; Rev. Proc. 2015-53)

B. Personal Exemption (See generally IRS Pub. 501, Exemptions, Standard Deduction, and Filing Information).

1. A personal exemption may be claimed only if another taxpayer is not entitled to claim the person as a dependent (I.R.C. §151(c)(2)).

2. The benefit of personal exemption is phased out for taxpayers with high

incomes (I.R.C. §151(d)(3)). (See table at para. III.C. above).

C. Exemption for Spouse (I.R.C. § 151(b)).

1. Automatic on a joint return. These exemptions are allowed whether or not a spouse has gross income or is a dependent of another taxpayer (though the other taxpayer will be denied an exemption) (Treas. Reg. § 1.151-1(b)).

2. On a separate return, the taxpayer may claim an exemption for a spouse only if the spouse has no gross income and is not the dependent of another (I.R.C. § 151(b)).

3. If the spouse is a nonresident alien, has no income from U.S. sources, and is not a dependent of another person, the taxpayer may claim an exemption for the spouse on a separate return.

D. Exemption(s) for Dependents (I.R.C. § 151(c)).

1. An exemption is allowed for each person who qualifies as a dependent. (I.R.C. § 151(c)).

2. All dependents must have social security numbers (I.R.C. § 151(e)).

3. Adoption Taxpayer Identification Numbers (ATINs).

a. Philadelphia Service Center of the IRS is the sole processing site for ATINs.

b. Taxpayers in the process of adopting a child and who meet the criteria for claiming dependent status (discussed below) but are unable to apply for a social security number (SSN) for the child pending adoption can apply for an ATIN.

c. ATINs are issued for domestic adoptions only. Taxpayers involved in adopting a foreign child must apply for an ITIN (Individual Taxpayer Identification Number).

d. Earned Income Tax Credit (EITC) is not allowed without a valid SSN. Therefore, EITC cannot be claimed while an ATIN is used on the return. After the adoption is final and the parents have a SSN for the child, they can amend the tax return to claim the EITC (if eligible)

e. Form W-7A is used by taxpayers to apply for ATINs.

4. Dependent Defined (I.R.C. § 152)

a. A Qualifying child or a Qualifying Relative

b. A Qualifying Child meets the following tests:

(1) Relationship

(a) Son, daughter, stepson, stepdaughter or a descendant of such child or

(b) A brother, sister, stepbrother, stepsister or a descendant of such relative.

(2) Age

(a) Child must not have attained the age of 19 by the end of the calendar year or

(b) Must be a student (attending on a full-time basis for at least 5 calendar months in a year at a qualified educational institution or qualified on-farm training program (I.R.C. § 152(c)(3) and (f)(2), who has not attained the age of 24

(c) Unless the child is totally and permanently disabled.

(3) Citizenship/Residence: Must be either a citizen or national of the United States. I.R.C. § 152(b)(3).

(4) Principal Place of Abode: The child must have the same principal place of abode of the taxpayer for more than one-half of the year. I.R.C. § 152(c)(1)(B).

(5) Support. The child must not provide more than one-half of his or her own support. I.R.C. § 152(c)(1)(D).

c. A Qualifying Relative meets the following tests:

(1) Relationship

(a) Son, daughter, stepson, stepdaughter or a descendant of such child;

(b) Brother, sister, stepbrother or stepsister;

(c) Father, mother or ancestor of either (i.e., grandmother or grandfather);

(d) Stepfather or stepmother;

(e) Son or daughter of a brother or sister of the taxpayer (i.e., nieces or nephews);

(f) Brother or sister of the father or mother of the taxpayer (i.e., aunts or uncles);

(g) Son-in-law, daughter-in-law, father-in-law, mother- in-law, brother-in-law, or sister-in-law; or

(h) An individual who for the year has the same principal

place of abode as the taxpayer and is a member of the taxpayer's household. I.R.C. § 152(d)(2).

(2) Gross Income. Individual must have less than $3,900 gross income for the 2013 calendar year.

(3) Support. The taxpayer must have furnished over half of the dependent's total support for that calendar year (exceptions for multiple support agreements and children of divorced/separated parents).

(4) Citizenship/Residency. Must be a citizen or national of the United States.

(5) Dependency. Must not be a qualifying child of the taxpayer or of any other taxpayer.

E. Under certain circumstances, a foster parent may be able to claim a foster child as a dependent despite receiving payments from a tax-exempt child placing agency or a state or one of its political subdivisions.

1. A foster child of a taxpayer shall be treated as a natural child of a taxpayer if the foster child meets the requirement that for the entire taxable year the foster child has the taxpayer's home as his principal place of abode and is a member of the taxpayer's household.

2. The receipt of foster care payments is relevant to whether the foster parent provides over one-half of the child's support. The payment in itself does not preclude a foster parent from claiming a dependency exemption for the foster child.

3. In calculating the support test, payments that the foster parent receives from a tax-exempt agency would count as the foster child's total support, but not count as support supplied by the foster parent. Therefore, if the foster parent provides over one-half of the foster child's total support, then the foster parent meets the support test.

4. See IRS Legal Memorandum, dated March 22, 1999 from George Blaine, Chief, Branch 1, Subject: Dependency Exemption for Foster Child, for Sandra West, Quality Assurance Coordinator, Richmond, a copy of which can be found at Tax Notes Today, 1999 TNT 94-27, Doc 1999-17644 (May 17, 1999).

F. Exemptions for Children of Divorced or Separated Taxpayers (I.R.C. § 152(e)).

1. General Rule.

a. The custodial parent is generally entitled to the exemption.

b. Custody is usually determined by the most recent decree of divorce or separate maintenance. If there is no decree, then it is determined pursuant to a separation agreement.

c. If neither a decree nor an agreement establishes custody, then the parent who had physical custody of the child for the greater part of the year is considered the custodial parent.

(1) Under this special rule the parent who had custody of the child for the greater part of the year, the "custodial parent," is generally treated as the parent who provided more than half the child's support.

(2) Focus on counting number of days of custody and not on amount of support provided.

d. The identity of the custodial parent is not always clear, particularly where the divorce instrument provides that the divorced parents have shared 50-50 physical custody of the child.

e. Practice Note: If a settlement agreement will provide for 50-50 shared custody and for alternating dependency exemption and dependent care credit between the parents from year to year, the agreement should identify which parent is the custodial parent for tax purposes.

2. Basic Requirements. (I.R.C. § 152(e)).

a. Child must receive over half of total support from both parents.

b. Parents must be divorced or separated pursuant to written agreement or decree, or have lived apart for last six months of calendar year.

c. Child must be in custody of one of the parents for more than one- half of the year (see Rownd v. Commissioner, T.C.Memo. 1994-465, 68 T.C.M. (CCH) 738 (1994) (After child reaches majority, regular 5-part dependency test "reapplies"--especially where one parent provides college financial support; dependency exemption then goes according to normal rules)).

3. Exceptions to General Rule (I.R.C. § 152(e)(2)).

a. Custodial parent waives right to claim the exemption.

(1) Waiver can be permanent, term of years or annual.

(2) Noncustodial parent must attach the waiver to his tax return when claiming the exemption (each year) (IRS Form 8332).

(3) Can an IRS Form 8332 be nullified?

(a) This question is not answered on the form itself or by any IRS publications, and the IRS has not published procedures for revoking the release.

(b) The only way a custodial parent can void a Form 8332 and claim the child on his or her return is to get the noncustodial parent to forego claiming that child as a dependent. If the two former spouses cannot agree and both claim the same child, then the IRS will step in and audit the returns. I.R.S. Legal Memo. 2000-07-

031.

(4) The Tax Court upheld the IRS in disallowing a noncustodial parent's claimed dependency exemption where he merely attached to his return a letter signed by his former wife which tracked the language of the divorce decree providing that the husband would be entitled to claim the children as dependents and that the wife would be required to sign any documents necessary to enable the husband to do so. The letter failed to state that the wife would not claim the children as dependents and lacked the other specific items of information required by the Code, Regulations, and Form 8332. White v. Commissioner, T.C. Memo 1996-438.

(5) Under a divorce decree, the wife had sole custody of children, but the husband was permitted to claim the children on his tax return as exemptions. The husband claimed the children on his tax return, but did not attach a copy of Form 8332. Instead the husband attached a copy of a portion of the divorce decree to the return. The IRS disallowed the claimed dependency exemption by the husband. The wife did not claim the children on her return, but several years later contended she is entitled to the exemptions. The Tax Court held the husband was not entitled to claim the child as dependency exemptions because he failed to satisfy the requirement that the noncustodial parent attach a declaration signed by the custodial parent confirming that she would not claim the children. The Tax Court held the custodial parent was entitled to the exemptions. Miller v. Commissioner, 114 T.C. 13 (2000).

(6) Practice Note:

(a) The custodial parent should insist on any releases to the exemption being conditional on child support payment being current.

(b) The noncustodial parent should insist on unconditional releases to avoid litigation in the event the custodial parent refuses to sign a release without cause.

(c) The Form 8332 does not contain a cancellation date. The custodial parent need only sign the form once, but the noncustodial parent must attach it to his or her return every year.

b. A multiple support agreement (I.R.C. § 152(c); IRS Form 2120, Multiple Support Declaration).

(1) If two or more people together pay over half of the support of a child or other individual, but no one person alone pays more than half, one of the payors may be treated as having provided over half the support and may claim the supportee as a dependent if:

(a) The taxpayer paid over 10% of the total support;

(b) If not for the support test, the taxpayer could claim the dependency exemption with respect to the supportee; and

(c) The claimant attaches to his or her tax return an IRS Form 2120 signed by every other person who meets the previous two requirements.

(2) Form 2120 indicates that the person who signs it will not claim the dependency exemption for that year.

c. The noncustodial parent is entitled to claim the child pursuant to a pre-1985 decree or agreement and provides over $600 support for the child. (I.R.C. § 152(e)(4)).

G. Significance of Claiming Dependency Exemption.

1. Either parent may claim a deduction for medical expenses paid for a child regardless of who claims the child as a dependency exemption (I.R.C. §§ 213(d)(5) and 152(e)(6)).

2. Custodial parent waiving exemption may also claim earned income credit (I.R.C. § 32).

3. Only the custodial parent may claim dependent credit even if the right to claim the child as a dependent is waived (I.R.C. § 21).

   a. The Code section does not allow the custodial parent to release the dependent credit to the noncustodial parent.

   b. Divorced or legally separated parents who seek to claim the dependent care credit for an under-13-year-old child must meet the custody test (that is where the child receives more than half of his support during the year from his parents and is in custody of one or both of the parents for more than half of the calendar year). That parent need not be able to claim the child as a dependent and may even have released the dependency exemption to the other parent. (I.R.C. § 21(e)(5)).

4. Child tax credit. (I.R.C. § 24)

   a. Amount: The amount per child (under 17) is $1,000 through 2014 and beyond.

   b. Eligibility for the child tax credit phases out $50 for every $1,000 the adjusted gross income exceeds the following thresholds for modified adjusted gross income:

      (1) $110,000 for married filing jointly,

      (2) $55,000 for married filing separately, and

      (3) $75,000 for single filers.

   c. Modified Adjusted Gross Income is AGI determined without regard to the exclusions for foreign earned income, foreign housing expenses.

   d. The parent who is "allowed a deduction" with respect to such child will

be entitled to the credit. But must be allowed to claim a dependency exemption for a child to take child tax credit (I.R.C. § 24(c)(1)(A))

(1) To claim the child tax credit, the parent must claim the child as a dependency exemption. The parent claiming the child tax credit must list the child as a dependency exemption on the tax form and include the qualifying child's name and social security number.

(2) If the custodial parent waives the dependency exemption, the noncustodial parent gets both the exemption and the child tax credit.

5. American Opportunity Credit, Hope Scholarship, or Lifetime Learning credits (I.R.C. § 25A).

a. American Opportunity Credit is a modification of the Hope scholarship credit for tax years 2009 through 2017. It allows for students who have already used the Hope Credit for two years to have another opportunity at an additional credit for qualified expenses. The American Opportunity Credit cannot be taken for more than 4 years for the same student (see Form 8863).

b. The American Opportunity Credit is the sum of 100% of the firs $2,000 of qualified tuition and related expenses, plus 25% of the next $2,000 of qualified tuition and related expenses for a total maximum credit of $2,500 per eligible student per year.

c. For tax years beginning <u>after December 31, 2017</u>, the Hope Scholarship Credit allows credit for 100% of first $1,000 of qualified education expenses, 50% of next $1,000. Total potential credit is $1,500. This credit applies only during the first two years of an eligible student's post-secondary education.

d. The Lifetime Learning Credit allows credit for 20% of the amount of qualifying education expenses paid on the first $10,000. Total potential credit is $2,000. This credit is available for all years of post-secondary education and for courses to acquire or improve job skills. It remains available for an unlimited number of years.

e. The American Opportunity Credit phases out ratably for taxpayers with modified AGI between $80,000 and $90,000 for single filers, $160,000 and $180,000 for joint filers. Note that the credit is not available for married filing separate filers (I.R.C. § 25A(i)(4)).

f. For taxable years beginning in 2009, a taxpayer's modified AGI (MAGI) in excess of $50,000 ($100,000 for a joint return) is taken into account in determining the reduction under § 25A(d)(2)(A)(iii) in the amount of the Hope Scholarship and Lifetime Learning Credits otherwise allowable under § 25A(a). Rev. Proc. 2006-53, 2006-48 I.R.B.

g. Must be allowed to claim a dependency exemption for a child to take the Hope or Lifetime Learning Scholarship credits (I.R.C. § 25A(f)(1)(A)(iii)).

h. If a child who is claimed as a dependent by another taxpayer incurs qualified tuition and related expenses, then the taxpayer, not the child, is deemed to have paid such expense for purposes of both the Hope and Lifetime Learning Credits.

i. Married taxpayers incurring qualified expenses must file a joint income tax return in order to claim the educational tax credits. No credit under I.R.C. §25A is allowed for married taxpayers filing separate returns. In order to claim the credit, the taxpayer must include the student's name and social security number on his or her return.

6. Planning Strategies for Dependency Exemption.

a. Which spouse will take the dependency exemption(s) and therefore be allowed the child tax credit and / or educational credits?

b. Analyze the true comparative tax savings of dependency exemptions and the child tax credit per child.

c. The credit is subject to a phase-out. (I.R.C. § 24(b)).

d. Many custody arrangements today are for shared or joint custody of the child where each parent has physical custody for 50% of the time. This situation should be addressed in the divorce instrument by stating who is or how the custodial parent will be determined on a year-to-year basis.

e. If the support test in the case of a child of divorced parents applies (I.R.C. § 152(e)), then parents can decide between themselves who will take the dependency exemption with respect to their child. While neither the Code nor the Regulations expressly say so, presumably the transfer of the deduction can be made on an ad hoc basis each and every year. Where the custodial and noncustodial parents are in different income tax brackets, the deduction is more valuable to the higher bracket parent.

f. On a joint return, the married couple can claim exemptions for all persons who are dependents of either or both spouses. On a separate return, a spouse can claim exemptions only for his or her own dependents.

g. If a husband and wife in a community property state file separate returns, then they can divide the total of their exemptions for dependents between them, but they cannot divide between them any exemption for any one dependent.

H. Effect of Death on Exemptions.

1. Personal (Treas. Reg. § 1.443-1(a)(2)).

a. The deduction for personal exemptions on a decedent's final return is not reduced because the return is for a short year. The full personal exemption is allowed on the descendant's final income tax return.

b. If one spouse dies during the year, then the survivor can claim the deceased spouse's exemptions on a joint return, unless the survivor remarries during the same year.

2. Dependent (Treas. Reg. §1.152-1(b)).

a. If a dependent died during the year, and the dependency tests were met for the part of the year he lived, the taxpayer can claim a full exemption for that dependent.

(1) The fact that the dependent was not in existence for the entire year is immaterial. If the dependent was born or died during the year, then it is sufficient if the dependent lived with the taxpayer during the year.

(2) This is true even if the child lived only for a moment. Whether the child was born alive depends on state or local law. There must be proof of a live birth shown by an official document, such as a birth certificate.

I. The personal exemption amount of a taxpayer whose adjusted gross income exceeds a specified threshold amount is reduced by an "applicable percentage" (I.R.C. §151(d)(3)(A). See section on Numerology for personal exemption phaseout thresholds.

J. On a joint return, the married couple can claim exemptions for all persons who are dependents of either or both spouses. On a separate return, a spouse can claim exemptions only for his or her own dependents.

K. If a husband and wife in a community property state file separate returns they can divide the total of their exemptions for dependents between them, but they cannot divide between them any exemption for any one dependent.

L. IRS Individual Income Tax Return Exemptions.

1. Check the appropriate block for "Yourself" and "Spouse" if applicable (line 6a and 6b).

2. On line 6c the taxpayer must specifically list each dependent.

3. Form preparation points to remember:

   a. On line 6c the taxpayer must specifically list each dependent to include:

      (1) The first and last name.

      (2) Each dependent's social security number (I.R.C. § 151(e)).

      (3) The dependent's relationship to the taxpayer.

      (4) A check to indicate if the taxpayer is the child to qualify for the child tax credit.

   b. On line 6d, add the total number of dependents being claimed (including spouse and self).

4. Multiply the total number of dependents claimed on line 6d times $3,950 and place the total amount on line 42 (page 2 of Form 1040).

XII. CONCLUSION.

CHAPTER F

GROSS INCOME

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CAUTION: This document is meant only as an educational outline for training purposes and as a starting point for conducting tax research. Many of the IRS publications and forms were not finalized at the time of the drafting of this document. Tax practitioners are highly encouraged to check the IRS website www.irs.gov for the latest publications reflecting the most recent tax legislation which changes constantly.

GROSS INCOME

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. IRS Forms and Instructions

B. Internal Revenue Code.

C. Treasury Regulations.

D. Home Page for the IRS (www.irs.gov)

E. IRS Publications:

1. 2016 Form 1040 Instructions.
2. Pub. 3, Armed Forces' Tax Guide.
3. Pub. 17, Your Federal Income Tax.
4. Pub. 525, Taxable and Nontaxable Income.
5. Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.
6. Pub. 4940, Tax Info for Active Duty Military and Reserve Personnel.
7. CCH, 2017 United States Master Tax Guide.

II. INTRODUCTION.

Extract From Front Side Form 1040

	d	Total number of exemptions claimed			Add numbers on lines above ▶
Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	
	8a	**Taxable** interest. Attach Schedule B if required		8a	
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.	b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
	9a	Ordinary dividends. Attach Schedule B if required		9a	
	b	Qualified dividends (see page 23)	9b		
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		10	
	11	Alimony received		11	
	12	Business income or (loss). Attach Schedule C or C-EZ		12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
If you did not get a W-2, see page 22.	14	Other gains or (losses). Attach Form 4797		14	
	15a	IRA distributions	15a	b Taxable amount (see page 25)	15b
	16a	Pensions and annuities	16a	b Taxable amount (see page 25)	16b
Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
	18	Farm income or (loss). Attach Schedule F		18	
	19	Unemployment compensation		19	
	20a	Social security benefits	20a	b Taxable amount (see page 27)	20b
	21	Other income. List type and amount (see page 29)		21	
	22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	

III. GROSS INCOME (FORM 1040, LINES 7-22).

A. General Principles.

1. Income includes "all income from whatever source derived" (I.R.C. § 61).

2. The person who earns income and is entitled to receive it cannot avoid tax by assigning it to another.

a. Income received for personal services is taxable to the person who earns it, even though he assigns it to another.

(1) This result is the same when the assignment is for income to be earned, (Lucas v. Earl, 281 U.S. 111, 50 S. Ct. 241 (1930)), or

(2) When the assignment is the right to income already earned for past services, (Helvering v. Eubank, (1940 S.

Ct.) 24 AFTR 1063).

(3) The same rule has been applied to other forms of the right to receive income, such as royalties (Nelson Littell v. Comm'r, 154 F.2d 922 (1945)), or an oil interest (Schermerhorn Oil Corp. et. al. (1942)).

3. Community property will be attributed to the spouse who earned it if the spouses file separate returns (I.R.C. § 66(a); see IRS Pub. 555, Community Property).

4. Income must be reported in year payment is actually received (cash basis, calendar year taxpayer) (I.R.C. § 451(a); Treas. Reg. § 1-451-1(a)).

5. A minor's income is income to him even though received by a parent (I.R.C. § 73(a)). (Note: Unearned income of a minor child will be discussed in detail later in this outline).

6. Foreign income of U.S. taxpayers.

a. U.S. citizens are generally subject to U.S. tax on all income earned, whether their income is derived from sources within or outside the U.S., or whether they are living within the U.S. or outside the U.S. while earning such income. (Treas. Reg. § 1.871-1(b)).

b. A resident alien's income is generally taxable in the same way as a U.S. citizen (Treas. Reg. § 1.871-1).

B. Gross Income Items.

1. All compensation for personal services, no matter what form of payment, i.e., cash or tangible items, must be included in gross income. (I.R.C. § 61(a)).

a. Income items include all forms of compensation for services, including wages, salaries, fees, commissions, bonuses,

termination pay, and severance pay. Specifically, for service members, the following items are included in gross income (see also Appendix A), (Treas. Reg. 1.61-2(a)).

(1) Basic pay.

(2) Special pay – sea duty, diving, medical and dental officer pay, proficiency pay, hazardous duty pay, imminent danger pay, accrued leave payment, foreign duty pay, continuation pay (including JAGC Continuation pay), flight duty, and Aviation Career Incentive Pay.

(3) Bonuses – enlistment and reenlistment bonuses, overseas extension bonus, separation pay, and student loan repayments.

(4) Personal money allowances (see Appendix B) (Rev. Rul. 77-350, 1977-2, C.B. 21).

(5) Payments received by a retired service member from a school district for services as a JROTC instructor are includible in the service member's gross income. It is irrelevant that the Government reimbursed the school district for the full amount of the payments. (Tucker v. Comm'r, T.C. Memo. 1999-373; 1999 Tax Ct. Memo LEXIS 428).

2. Fringe benefits provided to any person in connection with the performance of services are treated as compensation (Treas. Reg. § 1.61-21(a)(3)).

3. Interest (Form 1040, Line 8; Schedule B, Lines 1-4; I.R.C. § 61(a)(4); Treas. Reg. § 1.61-7) (See IRS Pub. 550, Investment Income and Expenses).

a. Reported to taxpayer on 1099-INT. (I.R.C. §§ 6049(a)(1), 6049(d)).

b. Interest received or credited to taxpayer's account is taxable income unless it is specifically exempt from tax (for example, interest on government bonds) (I.R.C. § 61; Treas. Reg. § 1.61-7).

c. Report taxable interest income on Schedule B, and the total of taxable interest on line 8a on Form 1040. (Treas. Reg. §1.6012-1(a)(6)).

d. Tax-exempt interest is listed on line 8b, Form 1040. (I.R.C. § 3012(d)).

e. A cash basis owner of Series EE discount bonds is generally taxed on the interest in the year he cashes in the bonds. The taxpayer does have the option of reporting the income and paying taxes on it each year rather than waiting. (I.R.C. § 454(c)).

(1) An individual who redeems any qualified U.S. savings bond in a year in which qualified higher education expenses are paid may exclude from income amounts received under such redemption, provided certain requirements are met. (I.R.C. § 135).

(a) Qualified higher education expenses include tuition and fees required for enrollment for either the taxpayer, spouse, or any dependent of the taxpayer for whom the taxpayer is allowed a dependency exemption. (I.R.C. § 135(c)(2)).

(b) Taxpayers are entitled to the exclusion if the redemption proceeds are contributed to a qualified tuition program.

(c) The amount that may be excluded is limited when the aggregate proceeds exceed the qualified higher education expenses paid that year. (I.R.C. § 135(b)(1)). Also, qualified educational expenses must be reduced by amounts received as qualified scholarships. (I.R.C. § 135(d)(1)). The

amount must be further reduced by expenses taken into account for the Educational Tax Credits. (I.R.C. § 25A).

(d) The exclusion is subject to phaseout in years in which the bonds are cashed and the tuition is paid. For 2016, the exclusion begins to phaseout for modified adjusted gross income above $116,300 for joint filers and $77,550 for other filers. The exclusion is completely phased out for modified adjusted gross income of $146,300 or more for joint returns and $92,550 or more for all other returns. (I.R.C. § 135(b)(2)(B). See Form 8815 and related instructions for further information on this exclusion.

(e) The exclusion is not available to married individuals filing a separate return. (I.R.C. § 135(d)(3)).

(f) The amount of excludable savings bond interest is determined by using Form 8815, and Schedule B, line 3.

4. Dividends (Form 1040, Line 9; Schedule B, Line 5-6; I.R.C. § 61(a)(7); Treas. Reg. § 1.61-9).

a. Reported to taxpayer on 1099-DIV. (I.R.C. § 6042(a), Treas. Reg. § 1.6042-2(a)(1)).

(1) Total Ordinary Dividends are reported in Box 1a. (2016 Form 1099-DIV)

(2) Qualified dividends are reported on Box 1b. (2016 Form 1099-DIV)

b. Dividends are fully includible in gross income. (I.R.C. § 301(c)(1)).

c. Dividend means any distribution made by a corporation to its shareholders, whether in money or other property, out of its earnings and profits. (I.R.C. § 316(a); Treas. Reg. § 1.316-1).

d. How Dividends Are Taxed to Shareholders

(1) Dividends received before 2003 are taxed as ordinary income to the shareholder in the year it is actually or constructively received (I.R.C. § 301(c)(1); Treas. Reg. § 1.301-1(b)).

(2) Qualified dividends received after 2002 are taxed to shareholders at the rates that apply to net capital gains (i.e., 0%, 15%, 20%) if they constitute "qualified dividend income" paid to noncorporate shareholders (I.R.C § 1(h)(11)) and otherwise at ordinary income rates, to the extent the distributing corporation has earnings and profits. (I.R.C. § 301(c)(1)).

(3) The part of a distribution in excess of earnings and profits is treated as a tax-free return of capital and is applied against (reduces) the shareholder's basis in the stock. (I.R.C. § 301(c)(2)).

(4) Any remaining excess (once basis is reduced to zero) is treated as payment for the stock, i.e., as capital gain if the stock is a capital asset in the shareholder's hands. (I.R.C. § 301(c)(3)).

e. Types of dividends. (I.R.C. §§ 301(a) & (b)).

(1) Ordinary dividends. Domestic corporations, cooperatives, insurance companies, real estate investment trusts, and loan associations pay these on capital stock. (I.R.C. §§ 316, 317, 318).

(2) Qualified dividend income.

Example 1. You bought 5,000 shares of XYZ Corp. common stock on June 28, 2016. XYZ Corp. paid a cash dividend of 10 cents per share. The ex-dividend date was July 6, 2016. Your Form 1099-DIV from XYZ Corp. shows $500 in box 1a (ordinary dividends) and in box 1b (qualified dividends). However, you sold the 5,000 shares on August 1, 2016. You held your shares of XYZ Corp. for only 34 days of the 121-day period (from June 29, 2016, through August 1, 2016). The 121-day period began on May 7, 2016 (60 days before the ex-dividend date), and ended on September 4, 2016. You have no qualified dividends from XYZ Corp. because you held the XYZ stock for less than 61 days. (See the Form 1040 Instructions)

Example 2. Assume the same facts as in Example 1 except that you bought the stock on July 5, 2016 (the day before the ex-dividend date), and you sold the stock on September 6, 2016. You held the stock for 63 days (from July 6, 2016, through September 6, 2016). The $500 of qualified dividends shown in Form 1099-DIV, box 1b, are all qualified dividends because you held the stock for 61 days of the 121-day period (from July 6, 2016, through September 4, 2016). (See the Form 1040 Instructions)

(a) For dividends received after 2002, qualified dividend income is dividend income received from domestic corporations and qualified foreign corporations (U.S. possession corporations and corporations eligible for benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program, but not foreign personal holding companies, foreign investment companies, or passive foreign investment companies.) (I.R.C § 1(h)(11)(B)(i)).

(b) Dividends paid by other foreign corporations also are qualified if paid on stock or American Depositary Receipts (ADRs) readily tradable on an established U.S. securities market. (I.R.C. § 1(h)(11)(C)).

(c) Qualified dividend income does not include the following: (**NOTE: Some of these dividends may be reported in Box 1b of Form 1099-DIV**)

(i) Dividends paid on stock unless the stock has been held for more than 61 days during the 121-day period beginning 60 days before the ex-dividend date (more than 91 days during the 181-day period beginning 90 days before the ex-dividend date for preferred stock dividends attributable to a period of more than 366 days) (I.R.C. §1(h)(11)(B)(iii)(I)). *See Examples 1-3.*

(ii) Dividends on stock to the extent that the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property (I.R.C. § 1(h)(11)(B)(iii)(II)).

(iii) Any amount that the taxpayer elects to treat as investment income to support an investment interest deduction (I.R.C § 1(h)(11)(D)(i)).

(iv) Dividends from corporations that for the distribution year or the preceding year are exempt from tax under I.R.C. § 501 (tax exempt organizations) or I.R.C. § 521 (exempt farmers' cooperatives (I.R.C. § 1(h)(11)(B)(ii)(I)).

(v) Dividends deductible under I.R.C. § 591 by mutual savings banks (I.R.C. § 1(h)(11)(B)(ii)(II)).

(vi) Dividends paid on employer securities owned by an employee stock ownership plan (ESOP), which are deductible under I.R.C. § 404(k). (I.R.C. § 1(h)(11)(B)(ii)(III)).

(d) Qualified dividend income does not include payments in lieu of dividends (typically made to owners of stock that has been lent in connection with a short sale), but only if the taxpayer knows, or has reason to know, that the payments are not qualified dividend payments.

(e) If an individual receives extraordinary dividends (within the meaning of I.R.C § 1059(c)) that are qualified dividend income, any loss on the dividend-paying stock is a long-term capital loss to the extent of the extraordinary dividends. (I.R.C. § 1(h)(11)(D)(ii)).

(3) Noncash and other dividends. A distribution of property or a sale of property for less than its fair market value by a corporation to a shareholder may be a taxable dividend. (I.R.C. §§ 316, 317, 318).

(4) Insurance policy dividends. Dividends paid on a life insurance policy are usually not taxable. They are rebates of premiums paid. (I.R.C. §§ 72(e)(2)(B), 72(e)(3)(B)).

(5) Reporting Dividends.

(a) Enter your total ordinary dividends on Form 1040, Line 9a. This amount should be shown in box 1a of your Form(s) 1099-DIV.

(b) Attach Schedule; Schedule B (Treas. Reg. §1.6012-1(a)(6)).

(c) Enter your total qualified dividends on Form 1040, Line 9b. Qualified dividends are eligible for a lower tax rate than other ordinary income. Be sure you use the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet, whichever applies, to figure your tax.

5. Taxable refunds of state and local income taxes (Form 1040, line 10).

a. Reported to taxpayer on 1099-G. Refunds of state and local income tax must be reported by the state or local tax authority/payor on Form 1099-G. (I.R.C. § 6050E; Treas. Reg. § 1.6050E-1).

b. Income tax refunded to a taxpayer is taxable to the extent the taxpayer received some benefit from claiming it as an itemized deduction on Schedule A of the federal tax return for the previous year. This is commonly known as the Tax Benefit Rule (I.R.C. § 111):

(1) This "tax benefit rule" applies to recoveries of both itemized deductions (i.e., taxes, medical expenses and other items deductible on Form 1040) and non-itemized deductions (for example, bad debts).

(2) The taxable amount is limited to the itemized deduction amount that

reduced the tax in the earlier year. A taxpayer who recovers an amount that he deducted in an earlier year as an itemized deduction is taxed on the lesser of the amount recovered, or the amount deducted on Schedule A.

(3) A taxpayer who wasn't required to itemize deductions in the earlier year is taxed on the lesser of his itemized deduction recoveries or the amount by which his itemized deductions exceeded the standard deduction.

In 2016, LTC and Mrs. Greenback received a $500 state income tax refund. The Greenbacks itemized their deductions on their federal return (Schedule A) in 2015 and claimed a state income tax deduction. If their 2015 itemized deductions exceeded their standard deduction by $500 or more, then the entire $500 is included in their gross income in 2016.

6. Alimony received (Form 1040, line 11; I.R.C. §§ 71, 61(a)(8), 62(a)(10), 215; Treas. Temp. Reg. § 1.71-1T) (See IRS Pub. 504 Divorced or Separated Individuals).

a. Certain payments, received as alimony or separate maintenance, are included in the recipient's gross income. (I.R.C. §§ 71, Treas. Temp. Reg. § 1.71-1T).

b. The payer may deduct from gross income those amounts paid as alimony or separate maintenance during such individual's tax year. (I.R.C. §§ 62(a)(10), 215).

c. These rules do not apply if the spouses file a joint return with each other. (I.R.C. § 71(e)).

d. Alimony requirements: The law defines an alimony (or separate maintenance) payment as any payment received by on or behalf of the payee spouse that meets the six conditions contained in I.R.C. §71 and Treas. Reg. § 1.71-1T, Q & A 2. These conditions are:

(1) Payments must be in cash. (I.R.C. § 71(b)(1), Treas. Reg. § 1.71-1T, Q & A 5-7).

(2) The divorce or separation instrument does not designate payments as nondeductible by the payor or excluded from the payee's income. (I.R.C. § 71(b)(1)(B), Treas. Reg. § 1.71-1T, Q & A 8).

(3) The parties must reside in separate households. (I.R.C. § 71(b)(1)(C), Treas. Reg. § 1.71-1T, Q & A 9).

(4) The payor spouse cannot be liable for payments after the death of the payee spouse. (I.R.C. § 71(b)(1)(D), Reg. §1.71-1T, Q & A 10-14).

(5) Payments cannot be treated as child support. (I.R.C. § 71(c), Treas. Reg. § 1.71-1T, Q & A 15-18).

(6) Payments cannot violate the excess front-loading rules. (I.R.C. § 71(f). See also Treas. Reg. § 1.71-1T, Q & A 19-25).

(7) In addition, to qualify for alimony, the parties must file separate returns. (I.R.C. § 71(e)).

7. Business Income (or loss) (Form 1040, line 12; Schedule C or C- EZ, I.R.C. § 61(a)(2)) (IRS Pub. 334, Tax Guide for Small Business).

a. Profit or loss from business or profession must be reported on Schedule C.

b. Generally, only individuals who carry on a "trade or business" as proprietors or partners, or who render services as independent contractors are self-employed and have self- employment income (see also Federal Form 1040, Schedule SE). These taxpayers may have income reported on a 1099-MISC, which will be used to prepare Schedule C.

c. For a business (or self-employment), gross income is usually the same as gross receipts, not gross profits. Gross profits are the total receipts from sales minus the cost of goods sold. (I.R.C. § 61(a)(2)).

d. Examples likely to be encountered: distributors of Amway, Avon, Tastefully Simple, etc.; dependent day care in home; child care providers; tutors; music teachers; musicians; private duty nurses; consultants; writers; and cleaning

services.

e. Generally, Military Tax Assistance Programs do not prepare tax returns involving business income. However, a special exception is allowed for Family Child Care Providers. (AR 27-3, para. 3-6i. See Chapter O). In addition, if the taxpayer brings a completed Schedule C, then it is permissible for the military Tax Assistance Program to perform the ministerial act of entering the Schedule C data into the taxpayer's tax return.

f. Taxpayers with business income may have to pay self-employment tax (Social Security tax). Discussed later in Chapter K (Other Taxes).

8. Capital gains or losses (Form 1040, line 13; Schedule D; I.R.C. §§ 1(h) & 61(a)(3)) (IRS Pub. 544, Sales and Dispositions of Assets).

a. Capital gains may be reported to taxpayer on a 1099-B, 1099-DIV, or 1099-S (Real Estate). Capital gains relating to sale of shares of stocks or mutual funds will be covered in detail in the class/outline at Chapter H, Tax Aspects of Stocks and Mutual Funds.

b. A capital gain or loss results from a sale or exchange of a capital asset (I.R.C. § 1201, et seq.).

c. What is a capital asset? (I.R.C. § 1221).

(1) Defined: any asset held whether connected with a trade or business except:

(a) Inventory held in the ordinary course of business. (I.R.C. § 1221(a)(1)).

(b) Depreciable property used in trade or business. (I.R.C. § 1221(a)(2)).

(c) Property held primarily for sale to customers in ordinary course of business. (I.R.C. § 1221(a)(1)).

(d) Copyrights, literary or musical compositions, memorandums. (I.R.C. § 1221(a)(3)).

(e) Accounts receivable acquired in the ordinary course of business. (I.R.C. § 1221(a)(4)).

(2) Examples. Almost everything the taxpayer owns is a capital asset, including:

(a) Investment property (e.g., mutual fund shares, stocks, bonds). (I.R.C. § 1221(a)).

(b) Property held for personal use, such as a personal residence, jewelry, automobile used for pleasure or commuting, coin or stamp collections. (I.R.C. § 1221(a)).

d. Significance of capital asset classification.

(1) The tax treatment of capital gains and losses depends on whether the gains and losses are long-term or short-term and on whether the taxpayer is a corporation or not.

(a) For noncorporate taxpayers, the maximum tax rate on net long-term capital gains is lower than the top rate on ordinary income.

(b) The maximum tax rate on long-term capital gains depends on the type of capital asset sold and the taxpayer's marginal tax rate (the top rate of tax on the person's ordinary income).

(c) The long-term capital gains of corporations are taxed at ordinary income tax rates and do not have a preferred tax rate. Similarly, short-term gains of corporations and of noncorporate taxpayers are taxed at the same rates as their ordinary income. The deduction for capital losses is limited,

but unused capital losses may be carried over to the next tax year.

(2) Net Capital Gains and Losses. Short-term capital gains and losses are netted, long-term capital gains and losses are netted, and then the net long- and net short-term gains are netted with each other. Further netting may be required if the taxpayer has capital losses as well as long-term capital gain subject to differing maximum rates of tax.

(a) Definitions:

(i) Short-term capital gain. The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for less than one (1) year, if and to the extent such gain is taken into account in computing gross income. (I.R.C. § 1222(1)).

(ii) Short-term capital loss. The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for less than one (1) year, if and to the extent that such loss is taken into account in computing taxable income. (I.R.C. § 1222(1)).

(iii) Long-term capital gain. The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than one (1) year, if and to the extent such gain is taken into account in computing gross income. (I.R.C. § 1222(3)).

(iv) Long-term capital loss. The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than one (1) year, if and to the extent that such loss is taken into account in computing taxable income. (I.R.C. § 1222(4)).

(b) Netting:

(i) Short Term Gains and Losses are netted:

(a) Short-term capital losses (including short-term capital loss carryovers) are netted against, or reduce, the total short-term capital gains, if any. The result is your net short-term capital gain or loss.Net short-term capital gains are taxable at ordinary income tax rates.

(b) A net short-term capital loss is used to reduce any net long-term capital gains from the 28% tax group, then to reduce any net long-term gains from the 25% tax group, then to reduce any net long-term gains from the 20% tax group, and finally to reduce net long-term gains from the 15% group.

(ii) Long-Term Gains and Losses are netted:

(a) Long-term capital gains and losses are similarly netted. Long-term capital gains and losses are first netted by category:

- Net section 1231 gain from Part I, Form 4797, after any adjustment for nonrecaptured section 1231 losses from prior tax years.
- Capital gain distributions from mutual funds and real estate investment trusts.
- Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
- Any long-term capital loss carryover

A net long-term capital loss from the 28% group (including long-term capital loss carryovers) is applied first to reduce any long-term gains from the 25% tax group, then to reduce any long-term gains from the 20% tax group, and then to reduce net long-term gains from the 15% group.

(b) A net loss from the 15% group is applied first to reduce net gain from the 28% group, then to reduce gain from the 25% group.

(iii) Long- and short-term capital gains/losses are netted with each other. Any resulting net capital gain that is attributable to a particular rate group is taxed at that group's marginal tax rate. (Notice 97-59, 1997-2 CB 309). If the result is a net capital loss, the difference is deductible. But there are limits on how much of the loss can be deducted and when it can be deducted.

(3) Maximum capital gains tax rate (I.R.C. § 1(h)).

IRS Publication 17, Table 16-1

IF your net capital gain is from ...	**THEN your maximum capital gain rate is ...**
collectibles gain	28%
eligible gain on qualified small business stock minus the § 1202 exclusion	28%
unrecaptured § 1250 gain	25%
other gain[1] and the regular tax rate that would apply is 39.6%	20%
other gain[1] and the regular tax rate that would apply is 25%, 28%, 33%, or 35%	15%
other gain[1] and the regular tax rate that would apply is 10% or 15%	0%

1 "Other gain" means any gain that is not collectibles gain, gain on small business stock, or unrecaptured section 1250 gain.

(a) The 20% maximum rate applies to "adjusted net capital gain" from sales on or after 6 May 2003 of property held

longer than twelve months and that would otherwise be taxed at (I.R.C. § 1(h)(1)(C)).

(b) Beginning in 2013, the Patient Protection and Affordable Care Act imposes an additional 3.8% surtax (net investment income tax) on net investment income of taxpayers that have modified AGI over $200,000 for Single and HOH), $250,000 for Married Filing Joint and Qualified Widower, and $125,000 for Married Filing Separate. (Treas. Reg. § 1.1411-2; see generally Treas. Reg. § 1.1411-1 through § 1.1411-10; IRS Form 8960).

(b) 25% maximum rate applies to long-term capital gain attributable to real estate depreciation (unrecaptured section 1250 gain). (I.R.C. §§ 1(h)(1)(E); 1(h)(6)).

(c) 28% maximum rate applies to (I.R.C. §1(h)(1)(F):

(i) The long-term capital gain from collectibles (as defined by I.R.C. § 408(m), but without regard to I.R.C. § 408(m)(3) — i.e., works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages, (I.R.C. §§ 1(h)(5) & (6)); and

(ii) I.R.C. § 1202 gain (commonly referred to a 28% rate gain) — i.e., the excess of the gain on the sale or exchange of qualified small business stock held for more than five years that would be excluded from gross income under I.R.C. § 1202 but for the percentage limitation in I.R.C. § 1202(a), over the gain excluded from gross income under I.R.C. § 1202. (I.R.C. § 1(h)(7)).

(iii) The gain subject to the 28% maximum rate may be offset by net short-term capital losses for the taxable year and long-term capital loss carryovers from prior taxable years. (Code Sec. 1(h)(4)).

(4) Qualified 5-year gain. The Jobs and Growth Tax Relief Reconciliation Act of 2003 effectively repealed the concept of 5-year gain. (I.R.C. § 1(h)(2) and (9), as amended by Act Sec. 301(b)(1)(A)). The American Taxpayer Relief Act of 2013 permanently repealed this provision.

e. Capital gains and losses are reported on Schedule D.

f. Losses from the sale or exchange of assets held for personal pleasure are not deductible unless the loss resulted from a theft or casualty in which case they may be deductible as ordinary losses (I.R.C. § 165(c)).

g. Capital Gains Distributions.

(1) Paid out of the net long-term capital gains of a corporation. Typically come from mutual funds, investment companies, or real estate trusts.

(2) Capital gains distributions are reported to taxpayers on Form 1099-DIV, and by the taxpayer on Schedule D, line 13. The taxpayer completes Schedule D to compute the net long-term capital gains or losses, and then computes the back of the schedule to determine the maximum capital gains tax.

(3) If the only amount a taxpayer has to report on a Schedule D is a capital gain distribution, as shown in box 2a of the Form 1099-DIV, then the taxpayer may be able to report that amount directly on Form 1040, line 13a or Form 1040A, line 10a.

(4) Note, however, the taxpayer will still need to complete a worksheet to take advantage of lower maximum capital gains rates.

9. Rents and royalties (Form 1040, line 17; Schedule E) (I.R.C. § 61(a)(5) & (6)) (See IRS Pub. 527 Residential Rental Property).

a. Rental income (or loss) is included in income (I.R.C. § 61(a)(5); Treas. Reg. § 1.61-8).

b. The owner of the property is entitled to deductions for depreciation, mortgage interest, taxes and other expenses of producing income. Advance rentals are included in the year received regardless of the year covered (Treas. Reg. § 1.61-8(b)). Also, amounts received by a lessor from a lessee for canceling a lease is included in income in the year received (Treas. Reg. § 1.61-8(b)).

c. Royalties are taxable income (I.R.C. § 61(a)(6); Treas. Reg. § 1.61-8(a)). Examples: the payment to the writer of a book or payments to owner of a patent.

d. Rental income (or loss) and Schedule E will be discussed in detail during the class/outline on Tax Aspects of Real Property.

10. IRA distributions (Form 1040, line 15, I.R.C. § 72(e)(5)(D)(iii)) (See IRS Pub. 590, Individual Retirement Arrangements).

a. Trustee notifies taxpayer on 1099-R. (Treas. Reg. 1.408-7).

b. Distributions are generally included in gross income from traditional IRAs. (I.R.C. § 72(e)(5)(D)(iii)).

c. IRA distributions are discussed in detail at Chapter G, Tax Aspects of IRAs.

11. Pensions and annuities (Form 1040, line 16, I.R.C. § 61(a)(9) & (11)) (See IRS Pub. 575, Pension and Annuity Income).

a. Generally reported to the taxpayer on Form 1099-R.

b. Pensions and retirement allowances are generally taxable to the recipient (I.R.C. § 61(a)(9); Treas. Reg. § 1.61-11(a)). Armed Forces retirement pay based on length of service is taxable. Review individual state laws regarding the taxation of Armed Forces pension and retirement pay as some states exclude this income from tax.

c. Members of the armed forces may be able to exclude certain disability pensions. The following are excludable:

(1) Payments are provided by the Department of Veterans Affairs are excludable (I.R.C. § 104(a)(4), 104(b)(2)(D); 38 U.S.C. § 5301).

(a) Those eligible are individuals with service- related injuries or sickness. While armed forces retirement pay based on length of service is taxable, that pay is excludable to the extent it could be received as disability compensation. (See also, Priv. Ltr. Rul. 2000-07-018 (Nov. 18, 1999)).

(b) If a taxpayer retires from the armed services and at a later date is given a retroactive service connected disability rating by the VA, and files a waiver for reduction of retirement pay in an amount equal to the VA disability compensation, the taxpayer does not include in income for the retroactive period the part of retirement pay he would have been entitled to receive from the VA during that period.

(c) A VA disability determination does not convert a military service retirement into a disability pension. The retiree has the burden of proving that pension payments that are received for a disability are incurred during active service in the military. (Scarce v. Comm'r, 17 T.C. 830, 833 (1951)).

(d) In some cases, a military retiree applies for disability benefits after retirement. Based upon the percentage disability determined by the VA, the retiree can elect to waive years of service retirement benefits to the extent of the VA benefits so that they can receive the VA benefits tax-free. In these cases, DFAS should make a reduction of retirement pay by the amount waved to receive the VA benefit. If DFAS makes this reduction properly, then the retiree cannot exclude a second amount of retired pay on account of the same disability. Proper reporting by DFAS will exclude the VA benefits from the retirement pay on Form 1099-R. (Dale C. Holt, et. ux. v. Comm'r, T.C. Memo. 1999-348, No. 187-98 (1999)).

(i) In 1996, taxpayer received a 100% disability rating that was retroactive to 1988. The taxpayer amended his tax returns and claimed a reimbursement of taxes already paid for what he claimed should retroactively be considered a tax-free disability compensation. The IRS agreed to refund taxes and interest for years 1993 to 1995, but the claims for 1988 through 1992 were disallowed because of the statute of limitations for refunds. The Court of Federal Claims held the statute of limitations (I.R.C. § 6511) bars the claim, and absent congressional action, the court could not create an exception to the statute of limitations for subsequent revisions to military disability benefits by the VA. (Sullivan v. U.S., 2000 U.S. Claims LEXIS 69).

(ii) Section 106 of the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) extends the period that a military retiree can get a refund for overpaid taxes to five years. This section applies when a retiree receives retired pay that is later determined to be tax-free disability compensation. However, the statute limits the taxable year starting the application to any year after 1 January 2001. Pub. L. No. 110-245, 122 Stat. 1624.

(2) Concurrent Retirement and Disability Program (CRDP): Ten-year, phased elimination of VA disability offset to 20-years-of-qualifying-service retired pay for members who have at least 50 percent service-connected disability rated by the VA. Pub. L. 108-136, §§ 641 and 642.

(3) Combat-Related Special Compensation (CRSC): Allows for concurrent receipt of military retired pay and VA disability pay for those with at least 10 percent VA-rated combat-related disabilities. Pub. L. 108-136, §§ 641 and 642.

(4) Non-VA Disability. Amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability

annuity payable under the provisions of section 808 of the Foreign Service Act of 1980. (I.R.C. § 104(a)(4)).

(a) However, this shall only apply in certain cases: (I.R.C. § 104(b)).

(i) An individual, who on or before September 24, 1975, was entitled to receive any amount described in subsection pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces. (I.R.C. § 104(b)(4)(A)).

(ii) An individual on September 24, 1975, who was a member of any organization (or reserve component thereof) the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, as referenced in subsection I.R.C. § 104(a)(4), or was under a binding written commitment to become such a member. (I.R.C. § 104(b)(2)(B)).

(iii) An individual who receives a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980, as described in subsection I.R.C. § 104(a)(4) by reason of a combat-related injury. (I.R.C. §104(b)(2)(C)).

(b) For purposes of this subsection, the term "combat-related injury" means personal injury or sickness which is incurred:

(i) as a direct result of armed conflict, (I.R.C. § 104(b)(3)(A)(i)),

(ii) while engaged in extra hazardous service, (I.R.C. § 104(b)(3)(A)(ii)), or

(iii) under conditions simulating war; (I.R.C. § 104(b)(3)(A)(iii)), or

(iv) which is caused by an instrumentality of war. (I.R.C. § 104(b)(3)(B)).

(5) Terrorist or military action. A taxpayer does not include in income disability payments received for injuries incurred as a direct result of a terroristic or military action. (I.R.C. § 104(a)(5); 692(c)(2)) (See IRS Pub. 3920, Tax Relief for Victims of Terrorist Attacks).

(a) Terroristic or military action defined:

(i) Any terroristic activity which a preponderance of the evidence indicates was directed against the United States or any of its allies, (I.R.C. § 692(c)(2)(A)) and

(ii) Any military action involving the Armed Forces of the United States and resulting from violence or aggression against the United States or any of its allies (or threat thereof). (I.R.C. § 692(c)(2)(B))

(b) For purposes of the preceding sentence, the term "military action" does not include training exercises.

(c) T-SGLI. Traumatic Injury Protection payments under the Servicemember's Group Life Insurance are also not taxable as income. (I.R.C. § 104(a)(3))

d. Special rules exist for taxing "qualified pension plans and employee annuities" (I.R.C. § 72(b); Treas. Reg. § 1.72-4(d)).

(1) If a payment under an annuity or endowment contract is received as an annuity payable at regular intervals over a period of more than one full year from the starting date, then all or part of it may be tax-free. The part of each annuity payment that represents return of investment (premiums paid) is excludable from the recipient's income until the entire investment is recovered. Excess receipts are fully taxable (I.R.C. § 72(b)(1); Treas. Reg. § 1.72-4(a)).

(2) The excludable portion is computed by multiplying each payment received by an exclusion ratio determined by dividing the investment in the contract by the contract's expected return as of the annuity starting date (I.R.C. § 72(b); Treas. Reg. § 1.72-4(a)).

(3) Once computed, an exclusion ratio is applied to each annuity payment received under the contract until the total investment has been recovered tax- free (I.R.C. § 72(b); Treas. Reg. § 1.72-4(a)(4)).

12. Farm income (Schedule F; Form 1040, line 18, Treas. Reg. 1.61-4) (See IRS Pub. 225 Farmer's Tax Guide).

13. Unemployment compensation is fully taxable (I.R.C. § 85(a)) (See IRS Pub 4128, Tax Impact of Job Loss).

a. The taxpayer will receive a Form 1099-G showing the amount of the payments. (I.R.C. § 6050B).

b. Report the payments separately from wages on Line 19 of 1040, Line 13 of Form 1040A, or Line 3 of 1040-EZ.

14. Social security benefits (Form 1040, line 20; Form SSA-1099; Form SSA-1042S).

a. A portion of a taxpayer's social security benefits may be taxable (I.R.C. § 86).

(1) The includible amount is the lesser of one-half of the annual benefits received or one-half of the excess of the taxpayer's provisional

income over a base amount, at lower provisional income levels.

(2) At higher provisional income levels, up to 85% of the social security benefits may be included.

b. Supplemental security income (SSI) payments are not treated as social security benefits that may be partially includible in gross income.

15. Other Income (Form 1040, line 21). Use the Other Income line item to report any income not reported elsewhere.

a. Prizes and awards are included unless (I.R.C. § 74(a)):

(1) The prize is given in recognition of a charitable purpose,

(2) Recipient selected without any action on his part,

(3) Recipient is not required to render services, <u>and</u>

(4) Prize or award is transferred to a governmental unit or charity (I.R.C. § 170(c)(2); Rev. Proc. 87-54, 1987-41 IRB).

b. Gambling.

(1) Gain arising from gambling, betting, and lotteries is includible in gross income. (I.R.C. § 61(a); Revenue Ruling 83-130, 1983-2 CB 148 (Jan. 1, 1983), citing <u>Dunnock v. Comm'r</u>, T.C.M. 1980-449).

(2) A deduction of wagering losses is allowed only to the extent of the taxpayer's gains from similar transactions. (I.R.C. 165(d); Treas. Reg. § 1.165-10).

(3) Losses are "nonbusiness losses" and deductible only if itemized on Schedule A, Form 1040. However, if gambling is conducted as a business, the losses are deductible as a business loss, but only to the

extent of gains.

c. Gross income includes income from the discharge of indebtedness (I.R.C. § 61(a)(12)),

(1) Unless:

(a) Discharged in Bankruptcy (Title 11 U.S.C. § 32), or

(b) Discharge results from an agreement among creditors if immediately thereafter the taxpayer's liabilities exceed value of assets (Treas. Reg. § 1.61-12(b)).

(2) A taxpayer should receive a 1099-C indicating the amount of income from discharge of indebtedness. The income will be reported as "other income" on Form 1040, line 21.

(3) Exclusions of Certain Cancellations of Indebtedness by reason of the federally declared Midwestern Disaster Area. Pub. L. No. 110-343, § 702, Oct. 3, 2008. Gross income shall not include any discharge of indebtedness of a natural person whose place of abode on the applicable disaster date was located

(a) in the Midwestern disaster area or

(b) in the Midwestern disaster and such person suffered economic loss by reason of the Midwestern disaster area.

16. Tax on Unearned Income of Children (I.R.C. § 1(g); (see IRS Pub. 929, Tax Rules for Children and Dependents).

a. Children under 19, and age 24 for full-time students whose earned income is less than half of their support, may have to pay tax as if part of their unearned income (e.g., dividends, interest) had been received by their parents. In 2016, in general, the first $1,050 of the child's unearned income is tax-free, and the second $1,050 is taxed at the child's rate (usually 10%). Any

unearned income in excess of $2,100 for 2016 is taxed to the child at the parents' marginal rate.

b. Allocable parental tax means the tax that would be imposed on the parents' taxable income if their income included the net unearned income of all of the parents' children under 19 or age 24 and a full-time student whose earned income is less than half of their support.

c. If more than one such child is involved, you must determine each child's share of allocable parental tax.

d. Child's tax liability must be recomputed if there is a change in the parent's tax.

e. If child's parents are divorced, then the parental tax is based on the income of the custodial parent.

f. Reporting the income.

(1) On parents' return – Form 8814, Parents' Election to Report Child's Interest and Dividends.

(2) On child's return – Form 8615, Tax for Certain Children Who Have Unearned Income.

IV. ITEMS EXCLUDED FROM GROSS INCOME.

A. Military Benefits (Appendix A of this outline).

1. Gross income does not include "qualified military benefits" (I.R.C. § 134(a)).

a. Defined as any allowance or in-kind benefit received by a member or former member of the uniformed services of the U.S., or his dependent, and which was excludable from gross income on Sept. 9, 1986, under any provision of law or regulation (other than the Internal Revenue Code) in effect on that

date (I.R.C. § 134(b)(1)).

b. Under a limitation rule, a qualified military benefit does not include any modifications or adjustments of any benefit made after Sept. 9, 1986 (and thus the modification or adjustment must be included in gross income), unless:

(1) the modification or adjustment is provided in kind, or

(2) the adjustment is payable in cash, and the adjustment is:

(a) available under a provision of law or regulation as in effect on Sept. 9, 1986, and

(b) determined by reference to a fluctuation in cost, price, currency, or other similar index (e.g., a cost of living adjustment). (I.R.C. § 134(b)(2)).

c. Excludable benefits: veteran's benefits, medical benefits, professional education, group term life insurance, survivor and retirement protection plan premiums, subsistence, uniform, housing, overseas cost-of-living, evacuation, family separation allowances, death gratuities, interment allowances, various travel allowances, tuition assistance and dependent benefits (I.R.C. § 134(b))

(1) Dislocation allowances, temporary lodging allowances and expenses, move-in housing allowances provided in connection with permanent changes of station are excludable from income (Treas. Reg. § 1.61-2(b)(2)).

(a) Transportation allowances. The cost of transporting families and dependents paid by the government is not includible in gross income for the transfer is in the interest of the government and not for the benefit of the service member. Any excess of the allowance or reimbursement over the actual expenses incurred for such purposes is includible in gross income. (Rev. Rul. 54-429, 1954-2 C.B. 53).

(b) Dislocation allowance. (37 U.S.C. § 407 (2003)).

(c) Temporary lodging allowance (37 U.S.C. § 405(2003)) or expense (37 U.S.C. § 404a (2003)).

(2) Per Diem. Members of Armed Forces receiving per diem allowances are considered as having accounted to their employer for their travel and other business expenses and as such, the allowances are not taxable. (I.R.C. § 134; Priv. Ltr. Rul. 59-01-205 (Jan. 20, 1959)).

(a) However, the per diem or actual expense allowance, the monetary allowance in lieu of transportation, and the mileage allowance received by members of the Armed Forces, National Oceanic and Atmospheric Administration, and the Public Health Service, while in a travel status or on temporary duty away from their permanent stations, are included in their gross income except to the extent excluded under the accountable plan provisions of § 1.62-2. (Treas. Reg. 1.61-2(b)(3)).

(3) Family separation allowances. (I.R.C. § 134; Rev. Rul. 70-281, 1970-1 C.B. 16).

(4) Uniform gratuity or clothing allowance. (I.R.C. § 134; 26 C.F.R. § 1.61-2(b)(1)).

(5) Death gratuity.

(a) The National Defense Authorization Act for Fiscal Year 2006 amended 10 U.S.C. § 1478(a) increasing the amount of the death gratuity from $12,420 to $100,000 regardless of whether the death was in combat or of combat related causes. Previous to this change, 10 U.S.C. § 1478(c)), was enacted for deaths occurring after Sept. 10, 2001. (Act Sec. 102(a)). Including the increase in death gratuity to $100,000 for those who die in combat or of combat related causes. 10 U.S.C. § 1478.

(i) Any post-Sept. 1986 adjustments to the amount of death gratuities payable under the military death benefit provisions of the U.S. Code are not subject to the limitation rule discussed above, for deaths occurring after Sept. 10, 2001. (I.R.C. § 134(b)(3)(C), as amended by Act. § 102(b)).

(ii) Thus, the amount of the death gratuity for the eligible survivor of a service member who dies after 10 September 2001 is $100,000 and the entire amount can be excluded from gross income.

(iii) Note. As of July 1, 2008, 10 U.S.C. § 1477 was amended to allow the designation one or more persons to receive all or a portion of the amount payable under section 1478.

2. Exclusion of Compensation of Service Members Received in a Combat Zone (CZ) or Qualified Hazardous Duty Area (QHDA) from Gross Income.

a. Under the CZ/QHDA compensation exclusion tax rules, gross income does not include certain CZ/QHDA compensation of members of the Armed Forces. (I.R.C. § 112).

b. Any official presence in a CZ/QHDA during the month will qualify the service member for the CZ/QHDA exclusion for the entire month. Likewise, if a service member is hospitalized outside of the CZ/QHDA for part of a month as a result of wounds, disease, or injury incurred while serving in a CZ/QHDA, he qualifies for the CZ/QHDA exclusion for the full month so long as combatant activities remain in the CZ/QHDA. (Treas. Reg. § 1.112-1(b)(3)).

(1) Enlisted personnel serving in a CZ/QHDA during any part of any month may exclude from gross income all compensation received for active service for that month. (I.R.C. § 112(a)).

(2) The same compensation exclusion rule applies to commissioned officers. (I.R.C. § 112(b)).

(a) However, the amount excludable from income for officers is limited to the "maximum enlisted amount." (I.R.C. § 112(c)(5)).

(b) The term commissioned officer does not include a commissioned warrant officer. (I.R.C. § 112(c)(1))

(c) "Maximum enlisted amount" means the highest rate of basic pay for such month to any enlisted member of the Armed Forces of the United States at the highest pay grade applicable to enlisted members (I.R.C. § 112(c)(5)(A)), plus the amount of hostile fire or imminent danger pay (I.R.C. § 310) to an officer for the month. (I.R.C. § 112(c)(5)(B)).

c. Student Loan Repayment Made on Behalf of Service Members in a CZ/QHDA.

(1) An issue that arises periodically concerns the taxability of student loan repayments made on behalf of service members in a CZ/QHDA as part of the Department of Defense Loan Repayment Program.

(2) Generally, a loan repayment under the program is compensation for services, but it is excluded as CZ/QHDA compensation for the months in the CZ/QHDA. (Letter, Department of the Treasury, Internal Revenue Service, Office of Associate Chief Counsel (Employee Benefits & Exempt Organizations), to Lieutenant Colonel Thomas K. Emswiler, Deputy Chief, Legal Assistance Policy Division, Office of the Judge Advocate General, U.S. Army (12 Dec. 1997)).

(3) If a service member serves one or more days in a CZ/QHDA during a particular month, and is able to exclude compensation for that month as CZ/QHDA compensation, the service member is also entitled to exclude 1/12 of the loan repayment corresponding to that month's service.

d. Separation Payments to Leave the Military Accruing While a Service Member is in a CZ/QHDA.

(1) Compensation earned in a CZ/QHDA does not include pensions and retirement pay. (I.R.C. § 112(c)(4)).

(2) Similarly, a separation payment for an agreement to leave military service early in lieu of retirement, which accrues while the service member is on active duty in a CZ/QHDA, does not constitute compensation for active service in a CZ/QHDA, and is not excluded from gross income under the CZ/QHDA pay exclusion. A separation payment is not a payment for service in a CZ/QHDA, is a payment in exchange for an agreement to leave military service early and forego any right to pension benefits. The time and place of acceptance of the separation payment are irrelevant to this determination. (Waterman v. Comm'r, 179 F.3d 123 (4th Cir. 1999)).

e. Redux Payment of $30,000 while in a CZ/QHDA.

(1) The $30,000 Redux payment (15-year career status bonus) is considered taxable income, but the combat zone tax exclusion applies. See below. The authority for the payment is set forth in 37 U.S.C. § 354 (previously 37 U.S.C. § 322), as added by § 642 of the Fiscal Year 2000 Authorization Act (which is set forth in Subtitle D - Retired Pay Reform).

(2) The Redux bonus is characterized as a career bonus, a type of special pay, that is available to certain members who execute a written agreement to remain on active duty until they have completed 20 years of service (a 5-year service commitment). The Redux bonus must be paid no later than the first month that begins on or after the date that is 60 days after the date on which the Secretary concerned receives the election from the member. The Redux bonus is subject to recoupment on a pro rata basis if the member fails to complete 20 years of active duty service, unless recoupment is waived. These various characteristics of the Redux bonus seem very similar to the reenlistment bonus.

(3) CZ tax exclusion applies to the REDUX bonus, if the member executes the agreement to receive the bonus while serving in a

combat zone or QHDA. In addition, it appears that the payment should be reported on a W-2, rather than a 1099-R.

(4) Summary of Armed Forces Tax Council Meeting of message of May 9, 2000. This represents a change/correction of the material in previous outlines.

3. While the service member is entitled to the CZ/QHDA exclusion, income tax withholding does not apply to the excludable compensation. (I.R.C. § 3401(a)(1)).

4. Military pay for CZ/QHDA service is still subject to Social Security and Medicare taxes.

5. The Form W-2 will report the excluded military pay in the boxes indicated "Social Security wages" and "Medicare wages and tips." The IRS shows the excluded amount in block 12, as a code Q item. Code Q represents military employee basic quarters, subsistence, and CZ/QHDA compensation. Compensation for active service includes basic pay and certain other forms of compensation.

6. The other types of compensation excluded under the rules include:

a. Pay for accrued leave earned in any month served in a CZ/QHDA (Treas. Reg. § 1.112-1(b)(5), Example 2; IRS Notice 2000-17, 2000-9 I.R.B. 567, Q & A #6).

b. A reenlistment bonus if the voluntary extension or reenlistment occurs in a month served in a CZ/QHDA (Treas. Reg. § 1.112-1(b)(4), and (5) Example 5 & 6).

c. Awards for suggestions, inventions, or scientific achievements members are entitled to because of a submission they made in a month they served in a CZ/QHDA (Treas. Reg. § 1.112-1(b)(5), Example 4).

d. State bonus payments to service members while in the CZ/QHDA. Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) P.L. 110-245 Sec. 112.

7. The combat zone tax exclusion applies to continuation pay only if the agreement to perform additional years of service is signed by a member in a month in which the member is serving in a CZ/QHDA. The execution of the agreement is when the member accomplishes all acts necessary by the member to obtain entitlement to the payments. (Treas. Reg. § 1.112-1(b)(4), and (5) Examples 4, 5 & 6).

8. Service in direct support of military operations in a CZ/QHDA by performance of military service in an area outside the CZ/QHDA, results in the service member receiving CZ/QHDA tax benefits if they are receiving hostile fire or imminent danger pay. Service members meeting the criteria receive the same CZ/QHDA compensation exclusion benefits as individuals serving in the CZ/QHDA. (Treas. Reg. § 1.112-1(e)).

9. Tax Benefits for Service Members Missing in Action (MIA) or Prisoners of War (POW).

   a. A service member who becomes a POW or is MIA is considered to remain in active service in a CZ/QHDA. The period of service in a CZ/QHDA includes the period of time during which a service member is entitled to benefits pursuant to their status as missing. (I.R.C. §§ 112(d); 6013(f)(3); & 7508(d); Treas. Reg. § 1.112-1(b)(1)).

   b. A service member is in a "missing status" when he is officially carried or determined to be absent in a status of missing, missing in action, interned in a foreign country, captured, beleaguered, or besieged by a hostile force; or detained in a foreign country against his will and is entitled to continued pay and allowances based upon the missing status. (37 U.S.C. § 551(2); 37 U.S.C. § 552).

10. Death while Serving in a CZ/QHDA

   a. A service member who dies while in a CZ/QHDA is entitled to an abatement of the income taxes for the tax year in which the death occurs. The abatement also applies if the death occurred as a result of wounds, disease or injury incurred while serving in a CZ/QHDA. (I.R.C. § 692(a)).

   b. The income tax liability of a deceased service member is canceled for the last taxable year, ending on the date of death. The income tax liability is also canceled for any prior taxable year ending on or after the first day the service member served in a CZ/QHDA. (I.R.C. § 692(a)(1); Treas. Reg. § 1.692-1(a)(2)(i)).

c. Upon the death of a service member as stated above, the service member will not be assessed any amount of income tax for prior taxable years remaining unpaid as of the date of death. If any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, the assessments will be abated. If the amount of any such unpaid tax is collected after the date of death, the amount so collected will be credited or refunded as an overpayment. (I.R.C. § 692(a)(2); Treas. Reg. § 1.692-1(a)(3)).

d. Where a service member has filed a joint return with his spouse, the tax abated, credited, or refunded will be prorated as a portion of the joint tax liability. The amount abated, credited, or refunded shall be an amount equal to the portion of the joint tax liability which is the same percentage of the joint tax liability as a tax computed upon the separate income of the service member is the sum of the tax computed upon the separate income of the service member and his spouse. (Treas. Reg. § 1.692-1(b)).

e. If the service member was in a missing status, then the date of the death will be considered to be the date on which there has been a determination of death made. (I.R.C. § 692(b)).

(1) However, there will not be a forgiveness, abatement, or refund of taxes beginning more than two years after the date of termination of combatant activities. (I.R.C. § 692(b)(2)).

(2) Therefore, where a service member has been MIA in a CZ/QHDA and is found to have died in an earlier year, the surviving spouse is allowed to treat the date of death as either the date on which the official determination is made that the service member died, or the date two years after combatant activities in the CZ/QHDA have terminated, whichever is earlier. (I.R.C. § 2 (a)(3); Rev. Rul. 76-468, 1976-2 CB 202).

11. Tax Consequences of Military Survivor Benefits Attributed to Death in a CZ/QHDA

a. Dependency and Indemnity Compensation (DIC). DIC is not taxable as income to the recipient. (I.R.C. § 134(b)).

b. Survivor Benefit Plan (SBP). Compensation earned in a CZ/QHDA does not include pensions and retirement pay. I.R.C. § 112(c)(4). The payments to the beneficiaries under SBP are taxable as ordinary income despite the death occurring in a CZ/QHDA. (I.R.C. § 72(a), (n)).

c. Servicemembers' Group Life Insurance (SGLI). It is excluded from federal income taxation. (I.R.C. § 101(a)).

B. Amounts received under Defense Department's Homeowners Assistance Program are excluded from income and not subject to FICA tax (including Medicare).

1. If a military base realignment or closure causes adverse effects on housing values, then the Defense Department's Homeowners Assistance Program ("HAP," as authorized under § 1013 of the Demonstration Cities and Metropolitan Development Act of 1966, 42 U.S.C. 3374) pays certain employees and members of the Armed Forces to help offset those adverse effects.

2. HAP provides payments to eligible individuals who may elect to either:

a. Receive a cash payment as compensation for losses that may be or have been sustained in a private sale, in an amount not to exceed the difference between:

(1) 95% of the fair market value of their property as determined by the Defense Dept. before public announcement of intention to close all or part of the military base or installation, and

(2) the fair market value of the property at the time of the sale, or

b. Receive, as the purchase price for their property, an amount not to exceed 90% of the fair market value before the public announcement, as that value is determined by the Defense Department, or the amount of the outstanding mortgages.

3. Unless specifically excluded, gross income includes compensation for services, including fringe benefits. A fringe benefit provided in connection with the performance of services is considered to have been provided as compensation for those services.

a. Under pre-Military Family Tax Relief Act law, there was no specific exclusion for amounts received under HAP, and so those amounts were treated as having been received in connection with the performance of services.

b. Thus, any HAP payments for losses sustained in the private sale of, or foreclosure against a personal residence, were includible in gross income as compensation for services. Similarly, when the government bought a residence under HAP, any excess of the selling price over the fair market value of the residence at the time of sale was includible in gross income as compensation for services.

c. All HAP payments were subject to FICA tax (including Medicare) under pre-Act law.

4. For payments after the date of enactment (11 November 2003), the Act provides that "qualified military base realignment and closure" fringe benefits are specifically excluded from gross income. (I.R.C. § 132(a)(8), as amended by Act Sec. 103(a)).

a. "Qualified military base realignment and closure" fringe benefits are one or more payments made under HAP (in effect on the enactment date). (I.R.C. § 132(n)(1), as amended by Act Sec. 103(b)).

b. Thus, amounts received under HAP are both:

(1) Excluded from gross income, and

(2) Not subject to FICA taxes (including Medicare), since the amounts are not considered "wages" for FICA tax purposes.

c. The excludable amount of all HAP payments for any one property cannot exceed the amount payable under 42 U.S.C. § 3374(c)(1).

d. Thus, the excludable amount would be the amount received under HAP, which is not to exceed the difference between:

(1) 95% of the fair market value of the property as determined by the Defense Dept. before public announcement of intention to close all or part of the military base or installation, (42 U.S.C. § (c)(1)(A)(i)(I)), and

(2) the fair market value of the property at the time of sale. (42 U.S.C. § (c)(1)(A)(i)(II)).

C. Scholarships and Fellowships (see IRS Pub. 520, Scholarships and Fellowships).

1. Candidates for a degree may exclude amounts received as a qualified scholarship (I.R.C. § 117(a), (c)).

2. Qualified scholarship is any amount received for tuition and fees to enroll or attend an educational institution plus amounts used for fees, books, supplies and equipment (I.R.C. § 117(b)(2)).

3. Does not include payments for services and amounts received for room and board or travel. These must be included in gross income.

D. Foreign Earned Income Exclusion (I.R.C. § 911; see IRS Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad).

1. In 2016, qualified individuals may elect to exclude up to $101,300 of foreign earned income. (I.R.C. § 911(b)(2)(D)(i)).

2. They may also elect to exclude a limited amount of housing costs paid or incurred as a result of foreign service (I.R.C. § 911(a)(2)).

3. To qualify the individual must have a “tax home” in a foreign country, and:

a. Be a bona fide resident of one or more foreign countries for an uninterrupted period including an entire tax year; or

b. Be a resident, who, in any period of 12 consecutive months, is present in one or more foreign countries during at least 330 full days.

c. The temporary presence of taxpayer in the U.S. or the maintenance of a dwelling in the U.S. does not mean an abode in the U.S. (Treas. Reg. § 1.911-2).

4. Foreign income includes earned income from foreign sources.

a. Place of receipt is immaterial.

b. Income paid from U.S. Government sources or instrumentalities does not qualify.

5. Armed Forces assigned to NATO may not elect the foreign earned income exclusion for military compensation.

a. The IRS has concluded that service members assigned to NATO are employees of the U.S. and are ineligible to elect the exclusion of foreign earned income under I.R.C. § 911.

b. The IRS noted that a service member is assigned to NATO by the U.S. and performs services at NATO as a member of the U.S. military. Because the U.S. provides the member with benefits, pays the member's salary, and issues a Form W-2, the service member is an employee of the U.S. and, therefore, cannot take the foreign earned income exclusion.

6. Election made on Form 2555 or 2555-EZ.

E. Other Exclusions.

1. Property received as a gift, bequest, devise, or inheritance is excluded (I.R.C. § 102(a); Treas. Reg. § 1.102-1).

2. Child support (I.R.C. § 71).

3. Amounts received as damages on account of personal physical injuries are excludable from income. (I.R.C. § 104(a)(2)).

4. Amounts withheld from wages as contributions to a tax-deferred retirement plan (401(k), Thrift Savings Plan). Amount of deferred compensation reported on Form W-3 in Box 12 and designated with a code D.

5. Transitional compensation payments to abused dependents do not represent taxable income to the recipients because the payments represent financial assistance to the victims. However, if the abused dependent receives payments under the Former Spouses' Protection Act (FSPA), the FSPA payments are taxable income to the recipient, which is consistent with the tax treatment of all FSPA payments. Armed Forces Tax Council Opinion, 1994.

6. Frequent Flier Miles.

   a. On February 21, 2002, in Announcement 2002-18, the Internal Revenue Service (IRS) announced that it will not assert that an individual owes tax because of his receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to business or official (i.e., government-related) travel.

   b. There is, however, no tax relief for travel or other promotional benefits that are converted to cash, to compensation that is paid in the form of travel or other promotional benefits, or in other circumstances where these benefits are used for tax avoidance purposes.

V. KEY TO FORM W-2.

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

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

Form **W-2** Wage and Tax Statement 2016 Department of the Treasury—Internal Revenue Service

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

A. **Box 1: Taxable wages and tips.** This box does not include salary reduction contributions to a retirement plan (Thrift Savings Plan). Compensation shown in Box 1 must be reported on Line 7 of Form 1040 or 1040A, or Line 1 of Form 1040-EZ.

B. **Box 2: Federal tax withholdings**. This is the amount of federal income tax withheld from pay. This amount is entered on Line 61, Form 1040, Line 38, Form 1040A, or on Line 7, Form 1040-EZ.

C. **Boxes 3, 4, and 7: Social Security withholdings**. Wages subject to Social Security withholdings are shown in Box 3. Elective salary deferrals and combat zone compensation are included in Box 3. Box 4 indicates the amount of Social Security tax withheld. Box 7 indicates tips reported to an employer.

D. **Box 5 & 6: Medicare tax withholdings.** Wages subject to Social Security tax are also subject to Medicare tax. These wages are indicated in Box 5. In box 6, total Medicare withholdings are reported.

E. **Box 8: Allocated tips.** If a taxpayer worked in a business employing at least 10 people, the employer will report in Box 8 the taxpayer's share of 8% of gross receipts unless the taxpayer reported tips at least equal to that share. The amount shown is not included in Box 1 wages, but the taxpayer must add it to wages on Line 7 of Form 1040. The taxpayer cannot file Form 1040A or 1040-EZ.

F. **Box 9: Advance earned income payment.** If the taxpayer filed a Form W-5 asking for a part of the earned income tax credit to be added to wages, the amount of the advance is shown in Box 9. The taxpayer will report the advance as a tax liability when filing a Form 1040 or 1040A.

G. **Box 10: Dependent care benefits.** Reimbursements from an employer for dependent care expenses and the value of employer-provided care services under a qualifying plan are included in Box 10. Generally, amounts up to $5,000 are tax free, but the taxpayer must determine the amount of the exclusion on Form 2441 if the taxpayer files a Form 1040, or Schedule 2 if the taxpayer files a Form 1040A. The tax-free amount reduces expenses eligible for the dependent care credit.

H. **Box 11: Nonqualified plan distributions.** Distributions shown in Box 11 are from a nonqualified deferred compensation plan. These amounts are not reported separately because they have already have been included as taxable wages in Box 1.

I. **Box 12: Taxable fringe benefits.** If an employee received taxable fringe benefits, the employer has the option to show the amount in box 12 unless it is reportable in Box 10 or 13. These amounts are not reported separately because they have already have been included as taxable wages in Box 1.

1. **Elective deferrals to retirement plans**. If a taxpayer made elective salary deferrals to an employer retirement plan, "Retirement Plan" will be checked and the taxpayer's contribution is shown in Box 12 (codes used include D, E, G, H, and S). This includes payments to the Thrift Savings Plan.

2. **Travel allowance reimbursement.** Mileage allowance or per diem travel allowance that exceeds the IRS rate, the amount up to the IRS rate is shown in Box 12 using Code L. The excess is included as taxable wages in Box 1.

3. **Nontaxable sick pay.** If the taxpayer contributed to a sick pay plan, an allocable portion of benefits received is tax free and shown using Code J.

4. **Moving expense reimbursement.** Tax-free employer reimbursements to a taxpayer for deductible moving expenses are shown with Code P.

5. **Non-taxable Earned Income.** Block 12, Code Q, is used to report the non-taxable earned income of a service member, which can affect whether a service member qualifies for the earned income credit. Pursuant to an agreement reached between the IRS and the Armed Forces Tax Council Director, it was agreed that the only amounts that would be reported in Block 12 are BAQ, BAS, and pay excluded from taxation under the CZ/QHDA exclusion. Currently, the only amount being reported in Block 12 is CZ/QHDA pay excluded.

J. **Box 13.** If the "Retirement plan" box is checked, special limits may apply to the amount of traditional IRA contributions you may deduct. Also, the elective deferrals in box 12 (codes D, E, F, G, H, and S) (for all employers, and for all such plans to which you belong) are generally limited to $18,000 in 2016. See IRS Pub. 571.

1. **Statutory employee**. Taxpayers that have this box checked report wage income and deductible job expenses on Schedule C.

2. **Retirement Plan**. If the box "retirement plan" is checked, this indicates that the taxpayer was an active participant in an employer plan at some point during the tax year. As an active participant, the taxpayer may be unable to make a deductible IRA contribution or the IRA may "phase out." All active duty service members are active participants in an employer provided plan, and the "retirement plan" box will be checked for all active duty service members.

3. **Third-party sick pay**. Mark this checkbox only if you are a third- party sick pay payer filing a Form W-2 for an insured's employee. See Sick Pay Reporting in section 7 of Pub. 15-A.

K. **Box 14: Miscellaneous payments.** The taxpayer's employer may use Box 14 to report payments such as union dues, educational assistance, health insurance premiums, or voluntary after-tax contributions to profit sharing or pension plans.

L. **Box 15- 20: State and local taxes**. If the taxpayer itemizes the amount of state and local taxes withheld in Boxes 17 and 29 these amounts are deductible on Schedule A.

VI. TOTAL INCOME.

A. The taxpayer completes lines 7 through 21 of Form 1040 (and appropriate Schedules if necessary).

B. The total amount of income is indicated in line 22, Form 1040.

VII. CONCLUSION.

APPENDIX A

MILITARY PAYROLL TERMS - - TAX STATUS

Status	Pay Term	Definition
I	Accrued leave pay	Lump sum for unused accrued leave when term of service expires.
I	Aviation Career Proficiency Pay	Incentive pay for Aviation Officers.
X	Basic Allowance for Housing (BAH)	Paid to members of the Armed Forces for housing.
X	Basic Allowance for Subsistence (BAS)	Paid for subsistence including rations furnished in-kind to enlisted members.
I	Basic Pay	Pay for active duty, training duty, drills, back pay, and attendance at designated service school.
X	Combat Exclusion (pay excludable up to max. enlisted pay per month for commissioned officers)	Pay received under executive order placing the Armed Forces in a combat area.
I	Continuation pay	Paid to certain personnel who extend their active duty period.
X	Cost of Living	Pay for members overseas to offset allowances higher costs resulting from fluctuating exchange rates.
X	Death Gratuity	$100,000 paid to beneficiary(ies) of deceased service member.
X	Defense Counsel	Provided by the Armed Forces to represent military personnel in their defense before court-martial, Admin. Separation Board, or during an investigation.

Status	Pay Term	Definition
X	Dislocation Allowance	Payments to defray extra costs of moving from a permanent duty station.
I	Diving Pay	Pay for diving operations.
I	Enlistment Bonus	Payable to certain "critical-skilled" enlistees upon entering the Service.
X	Evacuation Allowance	Paid to offset expenses for dependents who must leave for a place of safety.
X	Family Separation Allowance	Paid when military families are separated due to overseas assignments, for emergencies, and for certain educational expenses for dependents.
I	Flight Duty Pay	Monthly pay supplement for flight time.
I	Foreign Duty Pay	Paid to enlisted personnel serving outside the 48 contiguous states and D.C.
X	Group-term life Insurance (SGLI/VGLI)	Military life insurance.
I	Hazardous Duty Pay	Pay for hazardous duty.
I	Imminent Danger Pay	Pay for duty in an area in which soldier is exposed to hostile fire or imminent danger.
X	Interment Allowance	Burial expense allowance.
I	Medal of Honor Pension	Pension for Congressional Medal of Honor holder.
I	Medical and Dental Proficiency Pay	Pay given to certain medical and dental officers.

X	Moving and storage	In-kind transportation and storage of household goods.
I	Nuclear Qualified	Pay to certain nuclear naval officers. officers pay
I	Overseas Extension Bonus	Paid to certain enlisted personnel upon extending their overseas tour.
X	Per Diem	An amount paid in place of subsistence and mileage When away from permanent duty stations.
I	Personal Money Allowances	Pay to high-ranking officers to defray expenses incurred in their official positions.
X	Professional Education	Education costs paid by the U.S. Government for Armed Forces personnel.
I	Proficiency Pay	Awards to enlisted personnel who show special proficiency in a military skill.
X	Qualified Hazardous Duty Pay	Exclusion of all military pay per month for enlisted personnel and warrant officers, limited to maximum enlisted rate plus imminent danger pay for officers.
X	Qualified Military Benefits	Any allowances or in-kind benefit paid to Armed Forces personnel or dependents that were excludable from gross income on 9 Sep. 1986.
I	Re-enlistment Bonus	Multiple of monthly basic pay times additional years of reenlistment service.
X	ROTC Educational and Subsistence Allowances	Paid for education and subsistence.

		LL.M. programs.
I	Sea Duty Pay	Paid for duty on a vessel under orders of a competent authority operating outside CONUS.
I	Separation Pay	Lump-sum payment paid upon involuntary discharge or release in certain cases.
I	Student Loan Repayment	Repayments from programs such as the General Educational Loan Repayment Program.
X	Subsistence Allowance	Paid for subsistence including basic allowance and other subsistence allowances and rations furnished in-kind to enlisted members.
X	Survivor and Retirement Protection Plan Premium	Premiums taken from the gross pay of retired personnel of the Armed Forces to provide a survivor annuity.
X	Trailer Allowance	Pay for moving a trailer from a permanent POD.
X	T-SGLI	Payment for traumatic injury under rider to SGLI.
X	Uniforms (In-kind or allowances)	Uniforms furnished enlisted personnel and allowances paid to officers.
X	Variable Housing Allowance	Paid to personnel living in a high cost of living area.
X	Veterans' Benefits	Amounts paid by the Department of Veterans Affairs, generally based on a combat-related disability.
I	Veterinary Pay	Pay given to certain Veterinary Corps Officers.

APPENDIX B

INFORMATION PAPER

DAJA-LA
9 September 2008

SUBJECT: Tax Treatment of the Personal Money Allowance

1. **PURPOSE:** To Provide Guidance on the Tax Treatment of the Personal Money Allowance (PMA).

2. **FACTS:**

a. Title 37, United States Code, section 414 provides that certain senior officers are entitled to a personal money allowance. Congress provided this allowance "in recognition of additional expenses peculiar to the military ranks or positions in question." H.R. Rep. No. 640, 80th Cong. 1st Sess. 12 (1947). Although Congress provided the allowance to defer these expenses peculiar to the military ranks or positions in question, the recipient may use it for any purpose or save it.

b. The Personal Money Allowance is included in the gross income of the recipient and is taxable. Rev. Rul. 77-350, 1977-2, C.B. 21. The amount paid as a personal money allowance is reflected on the officer's W-2 and is subject to federal and state income tax withholding. DEP'T OF DEFENSE FINANCIAL MANAGEMENT REGULATION, VOL. 7A, Chap. 31, para. 3103 (July 2008).

c. Amounts expended by PMA recipients for the Congressionally recognized additional expenses peculiar to the military ranks or positions in question are deductible as itemized deductions. Other ordinary and necessary business expenses are also deductible as itemized deductions, and some expenses of official entertainment, not peculiar to the officer's rank or position, are also deductible as itemized deductions.

d. Congress amended Internal Revenue Code § 62 in 1988. Under the amended provision, employees may not deduct business expenditures directly from income when they receive an allowance for them. Neither are they required to account to their employer for their expenditures nor are they allowed to keep amounts in excess of their expenditures. The recipient of a personal money allowance does not account to DoD for expenditures and may use it for any purpose or save it. As a consequence of this change, expenditures for official business are no longer directly deductible from income and are deductible only as itemized deductions.

e. To take such deductions the PMA recipient must:

(1) Itemize deductions on Form 1040, Schedule A, Form 2106 as Miscellaneous Itemized Deductions.

(2) Deductions are only allowed for amounts exceeding 2% of the PMA recipient's adjusted gross income.

3. **DISCUSSION:**

a. All "ordinary and necessary" expenses paid or incurred in carrying on a trade or business are deductible. A military officer is engaged in a trade or business. *Carlisle v. Commissioner*, 37 T.C. 424, 429 (1961); *Lindsay C. Howard*, 16 T.C. 157,161 (1951), *aff'd* 202 F.2d 28 (9th Cir. 1953).

b. Ordinary means common and accepted in the field of business. Necessary means helpful and appropriate for the business. Normal business expenditures such as the cost of professional journals, ACUs (only if not authorized for wear off-post), and insignia of grade are deductible as employee business expenses.

c. The officer must keep adequate records of these expenses in order to deduct them. The expenses are reported on either Form 2106-EZ or on Form 2106. The allowable deductions are carried over to Schedule A and are only deductible to the extent they (and all other miscellaneous itemized deductions combined) exceed 2 percent of the officer's adjusted gross income.

4. **ENTERTAINMENT EXPENSES:**

a. In addition to the ordinary and necessary tests, expenditures for entertainment must meet one of two other tests to be deductible:

(1) Directly Related Test. The main purpose of the combined business and entertainment was the active conduct of business, business was conducted, and the taxpayer had more than a general expectation of getting income or some other specific business benefit at some time in the future.

(2) Associated Test. The entertainment must be associated with the taxpayer's trade or business and directly precede or follow a substantial business discussion.

b. Application to the Military. Section 162(a) allows deductions for current business expenses while section 262 disallows deductions for "personal, living, or family expenses." The proper test to be applied in resolving the tension between section 162 and section 262 is "'whether the expense was business' or 'personal.'" *Fogg v. Commissioner*, 89 T.C. 310, 316 (1987).

(1) The Personal Money Allowance received by Lieutenant Generals and

Generals is gross income. However, Congress provided the allowance in recognition of the additional expenses peculiar to the military ranks or positions in question. *See* H.R.

Rep. No. 640, 80th Cong., 1st Sess. 12 (1947). To the extent that the officer expends these funds for their intended purpose of defraying certain costs incurred in connection with their official duties, the expenses will be deductible as ordinary and necessary business expenses. Rev. Rul. 77-350, 1977-2 C.B. 21.

(2) To deduct other expenditures for entertainment, the officer must establish that "the origin and character of the events or circumstances that give rise to the expenditures in question are directly related to petitioner's trade or business of being a military officer." *Fogg v. Commissioner*, 89 T.C. 310, 317 (1987).

(3) As a general rule, Internal Revenue Code section 274 limits the deduction for entertainment expenses to 50 percent of the amount expended. It also requires the taxpayer to keep adequate records of amounts expended on entertainment. Internal Revenue Code section 67 treats entertainment expenses as miscellaneous itemized deductions. Miscellaneous itemized deductions are deductible only to the extent they (and all other miscellaneous itemized deductions combined) exceed 2 percent of the taxpayer's adjusted gross income.

(4) To deduct any expense for entertainment, the officer must keep records that show the amount expended, the time, and place of the entertainment, and the business purpose and business relationships of the persons entertained. The officer must keep adequate records of these expenses in order to deduct them. The expenses are reported on either Form 2106-EZ or on Form 2106. The allowable deductions are carried over to Schedule A and are only deductible to the extent they exceed 2 percent of the officer's adjusted gross income.

5. **EXAMPLES:**

a. In *Fogg v. Commissioner*, a Marine lieutenant colonel deducted the costs associated with a change in command ceremony reception and the cost of contributions to a squadron unit fund. LTC Fogg introduced evidence that showed all commanders were required to engage in "official entertaining," including change in command ceremonies and that his career might have been jeopardized if he failed to contribute to the squadron fund. The Tax Court found that the reception was required by LTC Fogg's employer (even though he was not under a direct order to do so) and that they directly flowed from

a business ceremony (thereby satisfying the associated with test). The Court drew an analogy between the officer and a "hard-headed businessman" and determined that the businessman would have incurred the expenses. Because LTC Fogg convinced the Court that he was expected to contribute to the squadron fund or his career would be jeopardized, the Court ruled that the expenses were deductible being appropriate, helpful, and necessary for his career.

b. In *Pollock v. Commissioner*, 10 B.T.A. 1297 (1928), which is relied on in Fogg, the petitioner, a naval officer, was appointed as Governor of American Samoa. In connection with

his duties, the petitioner was required to extend courtesies to representatives of other countries; amounts for which the petitioner was not reimbursed (this would satisfy the directly related test). Refraining from making the expenditures, however, would not have been consistent with the petitioner's duties. The court determined that the continuance of the petitioner's naval standing, from which his income was derived, would have been seriously jeopardized had he failed to make the expenditures; therefore, the amounts paid out of his personal funds were deductible as ordinary and necessary expenses. Thus, while the officer in *Pollock* may not have been under a direct order, the Court recognized that one need not be threatened with a court martial in order for an expenditure of a military officer to be considered "necessary."

c. *Carlisle v. Commissioner*, 37 T.C. 424 (1961) held that expenses incurred in securing a medical discharge were not deductible because they were not ordinary and necessary to the business of being an Army officer. The Court had "difficulty in understanding how expenses incurred to expedite a discharge from the Army are ordinary and necessary in carrying on that business. Such expenses appear neither ordinary nor necessary to such a business under even the most broad reading of the statute." Similarly, it is unlikely that expenses incurred in connection with a retirement ceremony would be deductible.

d. Whether expenditure for entertainment in the military is an ordinary and necessary business expense (also satisfying either the directly related or associated with test) will be fact specific. As the court in Fogg noted, –[t]he military life is multifaceted in that it has business and social or personal aspects, both of which are steeped in traditions and customs. For example, there are social functions where, by custom and tradition, spouses are required to be present. Expenses of a spouse in attending the function may be incurred. We do not believe, however, that essentially personal expenses, such as for formal dress, would be rendered deductible by the custom and tradition requiring formal dress. This however, does not mean that the requirement of expenditure by "customs and traditions" may not be relevant. But, an inherently personal expense cannot be "converted into a business expense by a formalistic requirement of his employer that they be incurred. Rather, as already stated, the correct focus is on the nature of petitioner's business and the relationship between that business and the circumstances that give rise to the expense." *Fogg v. Commissioner*, 89 T.C. 310, 316-17 (1987).

6. For further information about the tax treatment of the Personal Money Allowance, see your servicing Legal Assistance Office.

LTC Janet H.
Fenton Legal Assistance Policy
Division Office of the Judge
Advocate General (703) 588-6721
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APPENDIX C

Date: July 16, 1999

MEMORANDUM FOR
David Morris, TSS and Michael Goodman, TLS Customer
Service, AC (International)

FROM:
Phyllis E. Marcus, Chief

SUBJECT

Treatment of Members of the Armed Forces Assigned to the North Atlantic Treaty Organization under Section 911.

[1] This technical assistance responds to your memorandum dated January 11, 1999, regarding the availability of the section 911 exclusion to members of the Armed Forces (service members) assigned to the North Atlantic Treaty Organization (NATO). Factual information that is the basis for this memorandum was submitted by Lt. Col. Thomas K. Emswiler, U.S. Army, Executive Director, Department of Defense, Armed Forces Tax Council (Tax Council). Technical assistance is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

ISSUE

[2] Whether service members assigned to NATO are eligible to elect the section 911 exclusion.

CONCLUSION

[3] In applying the common law test articulated in Adair v. Comm'r, T.C. Memo. 1995-493, acq., 1996-1 C.B. 1, service members assigned to NATO are employees of the United States under section 911(b)(1)(B)(ii) and are ineligible to elect the section 911 exclusion for foreign earned income.

FACTS

[4] The United States has the sole authority to assign its service members to any position, including assignment to NATO. Service members assigned to NATO fill positions that are either dedicated to the United States or have not been allocated to a particular nation. Service members are not permitted to compete for open positions at NATO, and neither a member nor NATO can compel the assignment of a particular individual. Once the United States assigns a service member to NATO, that position becomes the service member's appointed place of duty. A service member serving NATO is performing duty related to the member's military service.

[5] A service member is assigned to NATO pursuant to a written order from the United States advising the member of a permanent change of station (PCS), which orders the member to perform duty at NATO. All military transfers are initiated with a PCS order. The PCS specifies the start and end dates of the member's service at NATO. A service member does not have a separate contract with NATO and is not permitted to take a loyalty oath to NATO. A service member's duty is to support and defend the Constitution of the United States‖ and that duty may not be subordinated.

[6] The United States does not relinquish its right to control its service members assigned to NATO. The assigned member remains under the command of a United States Commander who exercises both administrative and judicial control over the member. For example, only the United States Commander (or another United States officer) can grant leave to the service member or take punitive action against the member. Only that Commander or (another United States officer) can initiate action to remove the member from the Armed Forces. At NATO, the service member may be supervised by a foreign military member, but that does not change the service member's paramount duty to the United States.

[7] If a member is absent from his or her place of duty without authority, the member's United States Commander can initiate punitive action in accordance with the Uniform Code of Military Justice (UCMJ). NATO generally lacks the authority to take punitive action against a member; however, in limited circumstances and only after coordination with the United States, NATO may relieve a member from the NATO position. However, relief from a NATO position does not affect the member's status as a member of the Armed Forces. The member's Service (Army, Navy, Air Force or Marines) would order the member to a new place of duty, or if appropriate, initiate action required to terminate the member from the Armed Forces either administratively or through UCMJ action. Although the member's misconduct at NATO would be the basis of the termination, only the United States, not NATO, can discipline the member.

[8] A service member is assigned to NATO by the United States and performs services at NATO as a member of the United States military. He represents the United States at NATO. He is under the command of a United States Commander and is evaluated by the United States Commander. The United States continues to provide the member with all benefits, pays the member's salary and issues a Form W-2. Both the service member and the United States intend that the member's relationship with the United States continue. For example, a service member may not cash out any accrued leave when assigned to NATO. A service member is not allowed to take a loyalty oath to NATO. A service member at NATO does not abandon his duty to the United States. The United States is engaging in an integral part of the business of government by allowing members of the Armed Forces to serve at NATO. NATO has no authority to remove a member from the Armed Forces and very limited authority to remove a service member from a NATO position. The service member's relationship with NATO is temporary.

[9] The information provided by the Tax Council does not specify how many service members are assigned to NATO or describe any specific positions a service member might fill at NATO. We assume that service members fill various positions at NATO.

DISCUSSION SECTION

911(a)(1)

[10] At the election of a qualified individual, section 911 (a)(1) provides a limited exclusion from gross income for foreign earned income. Section 911 provides that foreign earned income includes amounts received from sources within a foreign country as earned income for services performed, but does not include amounts —paid by the United States or an agency thereof to an employee of the United States or an agency thereof. Section 911(b)(1)(A) and (B)(ii).

THE ADAIR OPINION

[11] The issue in Adair was whether Mr. Adair, a civilian, who performed services for NATO as a transferee transferred and paid by the U.S. Army, was an employee of the United States or NATO for purposes of section 911. The Tax Court concluded that Mr. Adair was an employee of NATO; accordingly, he was entitled to the foreign income exclusion of section 911.

[12] Mr. Adair was employed by the U.S. Department of the Army (DOA) as a program analyst in the Office of the Comptroller of the Department of Defense (DOD). He was appointed by the Secretary General of NATO to the post of senior statistician in 1986. By electing to be recruited by NATO on a "reimbursable" basis, Mr. Adair would receive his salary and emoluments directly from the DOA at the salary level applicable to his former grade as a U.S. employee.

[13] When Mr. Adair transferred to NATO he was covered by the transfer provisions of the Federal Employees International Organization Service Act (FEIOSA), Pub. L. 85-795. Congress enacted FEIOSA in 1958 to encourage details and transfers to international organizations by Federal employees. FEIOSA defines a transfer as a change of position by an employee from an agency to an international organization. 5 U.S.C. section 3581(4). In general, an employee who transfers to an international organization retains coverage, rights and benefits in the various employee benefits offered to Federal employees, including health benefits and participation in the applicable retirement plan. A transferee may retain accumulated annual leave or elect to receive payment of such leave in a lump sum. Provided the transferee timely applies, the transferee has an absolute right to reemployment with the agency in his former or a similar position. Upon reemployment, the employee's sick leave account is reinstated.

[14] Thus, Mr. Adair was entitled to and continued to participate in the U.S. Civil Service Retirement System, and in health and life insurance programs available to U.S. employees, and he was granted the right to be reemployed by the agency from which he was transferred following his tenure with NATO.

[15] Mr. Adair acquired employment with NATO by applying for a position NATO advertised. When he commenced employment with NATO he was required to execute the following oath:

I solemnly undertake to exercise in all loyalty, discretion and conscience the functions entrusted to me as a member of the staff of NATO, and to discharge these functions with the interests of NATO only in view. I undertake not to seek or accept instructions in regard to the performance of my duties from any government or from any authority other than the Organization.

Adair, T.C. Memo. 1995-493.

[16] NATO required Mr. Adair to work full time and personally render his services. NATO authorities dictated the results that he was to accomplish, the means by which he was to attain those results, and it retained the right to control the order and sequence of the tasks that he performed. His performance was evaluated by a NATO supervisor. NATO personnel regulations established the details of employment concerning work hours, holidays and leave rights. NATO provided insurance coverage and Mr. Adair also received educational benefits.

[17] Among the arguments rejected by the Tax Court in Adair was the Service's assertion that under the applicable treaties and agreement, Adair was a U.S. employee seconded to NATO, making it unnecessary to consider the facts and circumstances. The Service argued that the treaty framework created by the Agreement on the Status of the North Atlantic Treaty Organization (Ottawa Agreement), 5 U.S.T. 1087, T.I.A.S. 2992, and the Agreement Concerning the Employment by the North Atlantic Treaty Organization of United States Nationals (London Agreement), 5 U.S.T. 1112, T.I.A.S. 2992, gave the United States the ability to tax the amounts it paid its U.S. citizens where it hired its citizens and assigned them to NATO's international staff. The Service further argued that in inserting the word “employee” in 1981, Congress only intended to carve out from the exception to the section 911 exclusion those persons who were their own employers, i.e., independent contractors, and did not intend to reach the “seconding” case of an individual employee of one employer (the United States) seconding to another employer (NATO). The Service argued that in the seconding case it was appropriate to adopt a special, broader definition of “employee” to effectuate the purposes of section 911 and the treaty structure created by
Ottawa Agreement and the London Agreement.

[18] The Tax Court concluded that section 911, as amended by Section 111(a) of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. 97-34, had modified the applicable treaties and agreements; hence the benefits of section 911 extend to individuals who receive compensation from the United States, but who are not employees of the United States. Thus, it found it necessary to decide whether the United States government or NATO was Mr. Adair's common law employer.

[19] The court first analyzed the conditions of a transferee's employment at NATO. It concluded that the transfer process to NATO for a Federal employee was a joint endeavor between the United States and NATO, and agreed with the Service that NATO hirees could be accepted only with the consent and at the discretion of the head of the U.S. agency, as well as the Secretary General of NATO. Although the United States could deny a transferee's request to

extend an agreed term, the court rejected the Service's contention that the United States could require a transferee's return or terminate the employment with NATO before expiration of the agreed upon term. Even if the United States denied the request to extend a term, a transferee could choose to stay beyond his agreed upon term and thereby forfeit reemployment rights. The court emphasized that NATO's rights to terminate employment were "markedly broader than the rights of the United States". Specifically, NATO could terminate Mr. Adair or any transferee not only upon the expiration of his term, but also due to disciplinary action, unsatisfactory performance, or if the country of which he was a national ceased to be a NATO member, withdrew, or failed to renew a security clearance. The court found Mr. Adair's receipt of employee benefits from the United States did not conclusively determine that he was an employee, but rather that someone believed he was eligible for the benefits.

[20] The court also held it was unclear from the facts that the United States intended to continue its employment relationship with Mr. Adair. Rather, the court concluded that the United States sought to encourage transfers and to further encourage the reemployment of transferees upon the expiration of their terms. The court noted that Congress enacted FEIOSA to encourage details and transfers to international organizations, and such transfers were encouraged by providing benefits and reemployment rights to transferees.

[21] The Service also argued that even though Mr. Adair may be an employee of NATO under the common law test, he remained an employee of the United States for purposes of section 911 due to the benefits and rights he retained as a transferred employee. The court rejected this argument stating, "the determination of whether petitioner was an employee of the United States depends on all the facts and circumstances, including the PARAMOUNT FACT THAT NATO, RATHER THAN THE UNITED STATES, CONTROLLED THE MANNER in which his work was performed." Adair citing Matthews v. Comm'r, 92 T.C. at 360. (Emphasis added.)

[22] As a result of the Adair opinion, the Service issued an AOD stating that it would acquiesce in the Adair opinion and no longer take the position that a transferee to NATO who is paid by the United States transferring agency, but who is otherwise a common law employee of NATO, is necessarily barred from claiming the section 911 exclusion. Adair v. Comm'r, Action on Decision, 1996-002 (March 4, 1996).

THE COMMON LAW RULES DEFINING EMPLOYEE

[23] Section 911 does not define the term "employees of the United States." However, according to section 3121, "employee" is defined to include "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." The legal test under the common law to determine whether an individual is an independent contractor or an employee is whether the alleged employer had the "right to control" the alleged employee, not whether the alleged employer actually exercised that right. Weber v. Comm'r, 103 T.C. 378 (1994), aff'd per curiam, 60 F.3d 1104 (4th Cir. 1995); Professional & Executive Leasing, Inc. v. Comm'r, 89 T.C. 232, aff'd, 862 F.2d 751 (9th Cir. 1988); McGuire v. United States, 349 F.2d 644 (9th Cir. 1965); James v. Comm'r, 25 T.C. 1296 (1956). Courts that have considered whether a worker is an employee under section 911 have applied the common

law test. See, Adair v. Comm'r, T.C. Memo. 1995-493; Juliard v. Comm'r, T.C. Memo. 1991-230.

[24] To determine the employment relationship between the parties, courts consider various factors to determine whether the alleged employer had the right to control the alleged employee. Courts have recently focused on the following factors to examine the relationship between the parties:

1. the right to control the manner in which the work is performed;

2. whether the individual performing the work has an opportunity for profit or loss;

3. the furnishing of tools and the work place to the worker;

4. the permanency of the relationship;

5. the right to discharge;

6. whether the service rendered is an integral part of the alleged employer's regular business;

7. whether services are offered to the general public rather than to one individual;

8. the relationship the parties believe they are creating; and

9. whether fringe benefits are provided.

Adair v. Comm'r, T.C. Memo. 1995-493; Juliard v. Comm'r, T.C. Memo 1991-230.

[25] Usually, cases that consider the above factors are concerned about whether a worker is an employee or an independent contractor, but the principles are equally applicable to determine by whom an individual is employed. See Professional & Executive Leasing, Inc., 89 T.C. 232, aff'd, 862 F.2d 751 (9th Cir. 1988).

ANALYSIS

[26] The information received from the Tax Council suggests that the United States has the right to control its service members far in excess of the right found in typical employer-employee relationships, regardless of where the service members are assigned to perform duty. Arguably, therefore, service members are per se employees of the United States. Nonetheless, it is appropriate to analyze the circumstances of the service member's assignment under the common law test. Applying the common law test to service members assigned to NATO, /1/ we conclude

that the members are employees of the United States. It should be noted that the exception to section 911 requires only a determination of whether the individual is an employee of the United States, not whether the individual is an employee of ONLY the United States. The facts in this case support the conclusion that a service member assigned to NATO is an employee of the United States and not of NATO. However, the common law includes a doctrine of coemployment, under which an individual may have a separate employment relationship with each of two parties, thereby being an employee of each. Therefore, a conclusion that an individual is an employee of NATO would not necessarily preclude a conclusion that the individual is also an employee of the United States for purposes of section 911.

[27] A service member is assigned to NATO by the United States and performs services at NATO as a member of the United States military. He represents the United States at NATO. He is under the command of a United States Commander and is evaluated by the United States Commander. The United States continues to provide the member with all benefits, pays the member's salary and issues a Form W-2. Both the service member and the United States intend that the member's relationship with the United States continue. For example, a service member may not cash out any accrued leave when assigned to NATO. A service member is not allowed to take a loyalty oath to NATO. A service member at NATO does not abandon his duty to the United States. The United States is engaging in an integral part of the business of government by allowing members of the Armed Forces to serve at NATO. NATO has no authority to remove a member from the Armed Forces and very limited authority to remove a service member from a NATO position. The service member's relationship with NATO is temporary. These facts, in addition to the actual control exercised by the United States, lead to the conclusion that the service member is an employee of the United States who is merely assigned to NATO.

[28] Two facts suggest that a member of the Armed Forces assigned to NATO is employed by NATO. First, NATO furnishes the workplace. However, this is generally not a determinative factor. Second, a service member assigned to NATO might have a foreign military commander as his supervisor. The exercise of day-to-day supervision indicates the right to direct and control the worker. In Adair, the Tax Court noted NATO's exclusive direction over Mr. Adair's daily activities, and thus, a court might find that actual control existed and based upon Adair conclude that NATO was the employer.

[29] Notwithstanding the above, Adair does not mandate the conclusion that a service member assigned to NATO is not an employee of the United States. The circumstances of a service member assigned to NATO are quite different from those of a civilian transferee under FEIOSA. Service members are not governed by FEIOSA. Unlike a civilian transferee, it is unnecessary to encourage service members to transfer to international organization. The United States orders a service member where to report for duty, and the member cannot object to the change of duty station. It is also unnecessary to provide reemployment rights because, when a service member is assigned to a new position, he does not terminate his relationship with the United States. Members are governed by the UCMJ and can be removed from their respective service only by the United States. Thus, even in circumstances where the service member is supervised daily by someone other than a United States Commander, Adair is distinguishable. Based upon all of the facts and circumstances discussed above, we conclude that the service members are employees of the United States.

[30] If you have any questions, please call Kate Y. Hwa at (202) 622-3840.

/s/ Phyllis E. Marcus
Phyllis E. Marcus Chief,
Branch 2
Office of Associate Chief Counsel
(International)

FOOTNOTE

/1/ We have considered a generic description of a service member assigned to NATO. We note that the results of applying the common law test may depend upon what position the service member holds at NATO.

CHAPTER G

ADJUSTMENTS TO INCOME

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. IRS Forms: Form 1040, Student Loan Interest Deduction Worksheet, Form 3903, Schedule SE, Self-employed Health Insurance Deduction Worksheet, Forms 1098-T, 1099-INT, & 8917.

B. Internal Revenue Code (I.R.C.) of 1986, as amended.

C. Treasury Regulations.

D. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.
2. Pub. 17, Your Federal Income Tax.
3. Pub. 334, Tax Guide for Small Business.
4. Pub. 521, Moving Expenses.
5. Pub. 535, Business Expenses.
6. Pub. 590, Individual Retirement Arrangements (IRAs)
7. Pub. 969, Health Savings Accounts & Other Tax-Favored Health Plans
8. Pub. 970, Tax Benefits for Higher Education

E. Forms: Form 1040, Form 8917, Form 3903, Form 2106, Schedule SE

II. INTRODUCTION.

A. **What is adjusted gross income?** Adjusted Gross Income (AGI). A term used with reference to individual taxpayers. Adjusted Gross Income consists of an individual's gross income less certain deductions and business expenses authorized under I.R.C. § 62

B. I.R.C. § 62, does not allow any deductions; it merely specifies which deductions allowed by other sections are taken into account in computing adjusted gross income.

C. The purpose of AGI is to distinguish those deductions allowable in all events from those that are allowed only if the taxpayer does not claim the standard deduction, e.g., itemize. It is also crucial to determine various phase outs for a number of deductions, adjustments, and credits.

D. I.R.C. § 62 deductions are commonly referred to as taken "above the line." on Form 1040.

III. EDUCATOR EXPENSE DEDUCTION. (§ 62 (A)(2)(D) AND 62 (D)).

A. For Tax years 2002 thru 2016, qualified taxpayers are entitled to an above the line deduction of up to $250.00 for unreimbursed expenses for the classroom ($500.00 if both spouses were educators). The Educator Expense deduction expired in 2013 but was extended through 2016 by S. 1946 – Tax Relief Extension Act of 2015.

B. For tax years 2017 and beyond, the above deduction is not allowed. I.R.C. § 62(a)(2)(D). It is unclear whether the deduction will be extended beyond 2016.

IV. RESERVE/NATIONAL GUARD TRAVEL EXPENSES (I.R.C. 162(P), FORM 2106)

A. The Military Family Tax Relief Act of 2003 amended the Internal Revenue Code to allow an above the line deduction for expenses incurred by members of the National Guard or Reserve in conjunction with their military service for expenses incurred after December 31, 2002.

1. The Act amended I.R.C. § 162 to provide that Reserve or National Guard members are deemed to be away from home in the pursuit of a trade or business for any period they are away from home in connection with their service.

2. This deduction is allowed whether or not a taxpayer elects to itemize (I.R.C. §62).

3. The above the line deduction is available only if the Servicemember must travel away from home more than 100 miles (and stay overnight) to attend National Guard or Reserve meetings.

4. The above the line deduction cannot exceed the applicable government per diem rate for the location. (I.R.C. § 62(a)(2) as amended by The Military Family Tax Relief Act of 2003).

B. If the above requirements are met, expenses for transportation, meals, and lodging (up to the per diem rate) are deductible on line 24 of Form 1040 as an above the line deduction.

C. Reporting Requirements:

1. If you have reserve-related travel that takes you more than 100 miles from home, you should first complete Form 2106, Employee Business Expenses, or Form 2106-EZ, Unreimbursed Employee Business Expenses.

2. Transfer the total of the expenses for reserve travel over 100 miles from home (up to the federal per diem rate) to Line 24, Form 1040. Federal per diem rates are available at http://www.gsa.gov/portal/category/100120.

3. If there are expenses incurred that exceed the federal per diem rate or involve travel under 100 miles from home, these expenses are available as a miscellaneous itemized deduction on Schedule A subject to the 2% floor on miscellaneous itemized deductions.

V. HEALTH SAVINGS ACCOUNT (FORM 8889) (I.R.C. § 223).

A. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 added section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts (HSAs) for tax years beginning after December 31, 2003.

B. HSAs are like IRAs created for the purpose of defraying unreimbursed health care expenses on a tax-favored basis. An HSA is a tax-exempt trust or custodial account with a financial institution where the taxpayer saves for future medical expenses. The interest or earnings on the assets are tax-free.

C. Within the limits, contributions to an HSA will be deductible if made by an eligible individual as an above the line deduction (Form 8889 and Line 25, Form 1040) and excludable from income if made by an employer on behalf of an eligible individual. If the employer makes the contribution on behalf of the employee, the amount of the contribution is not deductible by the employee as an HSA contribution or as a medical expense deduction.

D. Distributions from an HSA are tax-free when used to pay for qualified medical expenses. Distributions not used to pay for qualified medical expenses are penalized (10%) as well as taxed unless the taxpayer is disabled, over 65, or dies during the year.

1. Qualified medical expenses are expenses paid by the account beneficiary, his or her spouse or dependents for medical care as defined in I.R.C. § 213(d) if not covered by insurance or otherwise. Nonprescription drugs are not included as a qualified medical expense. I.R.C. § 223(d)(2)(A).

2. Qualified medical expenses must be incurred after the HSA has been established.

3. For purposes of determining the itemized deduction for medical expenses, medical expenses paid or reimbursed by distributions from an HSA are not treated as expenses paid for medical care under I.R.C. § 213 (i.e. are not deductible as itemized expenses for medical care).

E. In order to be eligible to contribute to an HSA, taxpayer must meet the following requirements:

1. Must be covered under a high deductible health plan (HDHP) on the first day of the month

2. Must not be covered by any other health plan that is not an HDHP (there are certain exceptions)

3. Must not be enrolled in Medicare (generally has not reached age 65)

4. May not be claimed as a dependent on another person's tax return.

F. An individual is ineligible for an HSA if the individual, while covered under an HDHP, is also covered under a health plan (whether as an individual, spouse, or dependent) that is not an HDHP.

1. An individual may maintain "permitted insurance" without losing eligibility for an HSA. Permitted insurance is insurance under which substantially all of the coverage provided relates to liabilities incurred under:

a. Workers' compensation laws,

b. Tort liabilities,

c. Liabilities relating to ownership or use of property (e.g. automobile insurance),

d. Insurance for a specified disease or illness,

e. Insurance that pays a fixed amount per day (or other period) or hospitalization.

2. Additionally, an individual may have coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

G. HSAs are established with a qualified HSA trustee or custodian, much like IRAs are established with qualified IRA trustees or custodians. No permission or authorization is necessary from the IRS to establish an HSA. An eligible individual who is an employee may establish an HSA with or without involvement of the employer.

H. The maximum contribution eligible taxpayers can make to an HSA is the sum of the limits determined separately for each month, based on status, eligibility and health plan coverage as of the first day of the month.

1. For 2016, the maximum monthly contribution for eligible individuals with self-coverage under an HDHP is $3,350, no change from 2015 levels.

2. For 2016, the maximum monthly contribution for family coverage under an HDHP is $6,750, a change of $100 from 2015 levels.

3. In addition to the maximum contribution amount, catch-up contributions may be made by or on behalf of individuals' age 55 or older, who are not enrolled in Medicare. The contribution limit is $1,000 for those eligible for catch-up contributions. There is no requirement the individual have earnings.

4. After an individual has attained age 65 (the Medicare eligibility age), contributions, including catch-up contributions, cannot be made to an individual's HSA.

5. Contributions that exceed the above limits are not deductible. In addition, an excise tax of 6% for each taxable year is imposed on the account beneficiary for excess individual and employer contributions unless the excess contributions and the net income attributable to the excess contributions are paid to the account beneficiary before the day prescribed for filing the federal income tax return.

I. A high deductible health plan is a plan that meets the following requirements:

1. If self-coverage only, has an annual deductible of at least $1,300;

2. If family coverage, has an annual deductible of at least $2,600; and

3. Annual out-of-pocket expenses for covered benefits does not exceed:

   a. $6,550 for self only coverage; and

   b. $13,100 for family coverage.

4. In the case of family coverage, a plan is an HDHP only if, under the terms of the plan and without regard to which family member or members incur expenses, no amounts are payable from the HDHP until the family has incurred annual covered medical expenses in excess of the minimum annual deductible.

J. Eligible seniors are able to establish medical savings accounts called Medicare MSAs. Eligible individuals are able to use MSA contributions to pay health care expenses. Medicare MSAs must be used in conjunction with a high deductible Medicare Advantage health plan. Medicare MSAs are administered through the Federal Medicare program. I.R.C. § 138. More information on these plans is available by calling 1-800-633-4227 or visiting http://www.medicare.gov.

VI. MOVING EXPENSES (FORM 3903) (I.R.C. § 62(A)(15), I.R.C. § 217(G)).

A. An employee or self-employed individual may deduct as an adjustment to income the expenses of moving himself and his family from one location to another if the move is related to starting work in a new location and the amount is reasonable. I.R.C. § 217.

B. The moving expense deduction is computed on Form 3903 and the amount allowed as a deduction is taken on Form 1040, line 26. Since this is an adjustment to income there is no need to itemize to take a moving expense deduction.

C. Generally, deductible moving expenses are limited to the cost of: (I.R.C. § 217(b))

1. Transportation of household goods and personal effects, and

   a. Items deductible include cost of packing, crating, cost of storing and insuring household good and personal effects within any period of 30 consecutive days after the day goods are moved from the former home and before they are delivered to the new home.

   b. Can deduct costs of connecting or disconnecting utilities required because of the move, shipping of car, and pet.

2. Travel (including lodging but not meals) to the new residence.

   a. Can include lodging expenses in the area of the former residence within one day after the taxpayer could not live in the former home because of furniture being moved out of the home.

   b. Includes lodging expenses for the day arriving at new residence.

D. Where an automobile is used in making the move, a taxpayer may deduct either:

1. The actual out-of-pocket expenses incurred (gasoline and oil, but not repairs, depreciation, etc.) or

2. A standard mileage allowance of 19.0 cents per mile for moves occurring during 2016 (a reduction of 4.0 cents per mile from 2015). Can include tolls and parking costs in addition if using the standard mileage allowance method.

E. Moving expenses do **not** include cost of meals and lodging for pre-move househunting trips; costs of meals and lodging (i.e., temporary living expenses); costs incident to sale (or lease) of old residence; costs incident to purchase (or lease) of new residence; car tags; and driver's license.

F. Generally, a taxpayer must meet a distance test, length of employment test, and a commencement of work test to be eligible to take the moving expense deduction. I.R.C. § 217(c), (d); Treas. Reg. § 1.217-2(a)(3), (d)(3). These tests do not apply if it is a PCS move. I.R.C. § 217(g).

G. Individuals that retire from an overseas job and return to the U.S. or a survivor (spouse or dependent) of any decedent who worked outside the U.S. (U.S. includes possessions of the U.S.) at the time of death are also eligible to deduct moving expenses if, within six months of the decedent's death, the survivor moves to the U.S. from a foreign residence that had been shared by the decedent. I.R.C. § 217(i).

H. Gross income does not include qualified moving expense reimbursements. These are amounts received from an employer as a payment for or reimbursement of expenses that would be deductible as a moving expense if directly paid or incurred by the employee. I.R.C. § 132(a)(6) and (g).

I. Any amount other than a qualified reimbursement received directly or indirectly by a taxpayer from the employer as a payment for or reimbursement of moving expenses must be included in the taxpayer's gross income as compensation for services. I.R.C. § 82.

J. Employers are required to give employees a statement showing a detailed breakdown of reimbursements or payments of moving expenses. Treas. Reg. § 31.6051-1(e).

K. Foreign moves.

1. A moving expense deduction is permitted in connection with the commencement of work at a new principal place of work located outside the U.S. and its possessions.

2. The rules are similar to the general moving expense deductions rules, except that a deduction is also allowed for reasonable expenses of moving household goods and personal effects from storage, and of storing them for part or all of the time during which the new place of work abroad continues to be a taxpayer's principal place of work. I.R.C. § 217(h).

L. Moving Expenses of members of the Armed Forces (I.R.C. § 217(g)).

1. A move by an active duty member of the armed forces under a military order and incident to a change of station can qualify for deduction regardless of the distance moved or the length of time worked at the new station. I.R.C. § 217(g). Therefore, a Servicemember that moves because of PCS does not have to meet the distance and time tests mentioned before.

2. A permanent change of station for purposes of this section includes:

a. A move from a home to the first post of active duty,

b. A move from one permanent post of duty to another, and

c. A move from the last post of duty to a home or to a nearer point in the U.S. The move must occur within one year of ending of active duty or within the period allowed under the Joint Travel Regulations.

3. If a Servicemember deserts, is imprisoned, or dies, a PCS for the spouse or dependent includes a move to:

a. The place of enlistment,

b. The member's, spouse's, or dependent's home of record, or

c. A nearer point in the U.S.

4. Cash reimbursements or allowances are excludable from income to the extent of moving and storage expenses actually paid or incurred, as are all in-kind moving and storage services provided by the military. This exclusion applies to the spouse and dependents of a servicemember when they do not accompany the member and move to a location different from that to which the Servicemember moves or different from that from which the Servicemember moves.

5. If total reimbursements or allowances received from the government because of the move are more than the actual moving expenses, the government should include the excess in wages on a Form W-2. This may be the case with some "Do it Yourself" moves or DITY moves. However, the excess portion of a dislocation allowance, a temporary lodging allowance, a temporary lodging expense, or a move-in housing allowance is not included in income.

6. Where the military moves the servicemember and the member's family to or from separate locations and they incur unreimbursed expenses, their moves are treated as a single move to the member's new principal place of work (I.R.C. § 217(g)).

7. No deduction is permitted for any moving or storage expense reimbursed by an allowance that is excluded from income (Treas. Reg. § 1.217-2(g)(6)).

8. If a Servicemember's reimbursements or allowances are less than the actual moving expenses, the Servicemember can deduct the expenses that exceed reimbursements and allowances (do not include value of moving or storage expenses provided by the government and do not include any part of dislocation allowance, a temporary lodging allowance, move-in housing allowance, or temporary lodging expense).

9. If the above requirements are met by a Servicemember, he/she can deduct reasonable unreimbursed expenses incurred for the following:

a. Moving of household goods and personal effects, including expenses for hauling a trailer, packing, crating, in-transit storage, and insurance.

b. Travel and lodging expenses from the old home to the new home, including automobile expenses and airfare.

10. Reasonable Expenses: Only expenses that are reasonable under the circumstances of the move qualify for the deduction.

VII. DEDUCTIBLE PART OF SELF-EMPLOYMENT TAX (SCHEDULE SE) (I.R.C. § 1401, I.R.C § 164(f))

A. The computation of self-employment tax will be discussed during the class/outline on "Tax Payments, Other Taxes, and Finishing the Return" at Chapter I.

B. If an individual is subject to the self-employment tax, the taxpayer may deduct from gross income the employer-equivalent portion (50%) of the self-employment tax imposed for the same tax year. I.R.C. § 164(f). The self-employment tax rate for self-employment income earned in Calendar Year 2015 is 15.3% (10.4% for Social Security and 2.9% for Medicare). Taxpayers cannot deduct the additional 0.9% Medicare (HI) self-employment tax imposed beginning in 2013 (I.R.C. 154(f)(1)).

C. The taxpayer will complete Schedule SE to determine the amount of self-employment tax, which will be entered on Form 1040.

VIII. SELF-EMPLOYED HEALTH INSURANCE DEDUCTION (I.R.C. § 162).

A. Some taxpayers may be able to deduct part of the amount paid for health insurance for themselves, spouse, and dependents if: (I.R.C. § 162(l))

1. The taxpayer was self-employed and had a net profit for the tax year, or

2. The taxpayer received wages from an S-Corporation in which they are more than a 2% shareholder.

B. The amount of the deduction is 100% of the total amount of health insurance coverage paid in the tax year. However, the deduction is limited to the taxpayer's earned income derived from the trade or business for which the insurance plan was established. I.R.C. § 162(1)(2)(A).

C. A self-employed person's health insurance deduction is treated separately with regard to plans that provide long-term care insurance and plans that do not provide long-term care insurance. I.R.C. § 162(l)(2)(B).

D. The amount of the deduction is computed using the worksheet in the instruction booklet for Form 1040 and then included as a deduction or adjustment to income on Form 1040.

IX. PENALTY ON EARLY WITHDRAWAL OF SAVINGS (FORM 1099-INT; FORM 1099-OID) (I.R.C. § 62(a)(9)) .

A. Depositors may withdraw funds from ordinary savings accounts any time they wish. However, if a depositor withdraws funds from a time deposit (such as a certificate of deposit) before the maturity date, a penalty is charged.

B. Interest that was previously earned on a time savings account or deposit with a savings institution and that is later forfeited because of premature withdrawals is deductible from gross income in the year when the interest is forfeited. I.R.C. § 62(a)(9).

C. Form 1099-INT or Form 1099- OID report the interest earned, as well as any early withdrawal penalties.

D. Taxpayers cannot subtract the early withdrawal penalty from the interest earned and report the difference. The early withdrawal penalty can be claimed as an adjustment to income on Form 1040, line 30. The entire penalty is deducted, even if it is greater than the interest income.

X. ALIMONY PAID (I.R.C. § 215)

A. Alimony and separate maintenance payments are taxable to the person receiving these payments. The person paying the alimony or separate maintenance can claim it as an adjustment to income. The adjustment can be claimed only on Form 1040.

B. The amount paid during the year and the recipient's social security number is entered on Form 1040.

C. General Rule. (I.R.C. § 71; Treas. Reg. § 1.71-1T).

1. Alimony payments are considered gross income to payee.

2. Deductible by the payor as a deduction/adjustment from gross income (I.R.C. § 62(a)(10) and 215(a)). The payor does not have to itemize to be allowed the deduction.

3. Alimony is treated as earned income so the divorced spouse may separately establish an IRA and contribute up to $5,500 per year or amount of alimony if less than $5,500 per year. I.R.C. § 219(b)(5).

D. Requirements for Alimony Tax Treatment (I.R.C. § 71).

1. Payments must be made in cash (I.R.C. §§ 71(b)(1), 215(b)). Debt instruments of the payor or a third party issued to or transferred to the payee are not considered cash payments. Treas. Reg. § 1.71-1T(b), Q&A-5.

2. Payments must be made and received under a qualifying instrument.

a. Includes a decree of divorce or separate maintenance, written separation agreement, or a decree requiring support or maintenance payments to a spouse.

b. The "instrument incident to a decree of divorce" generally describes writings containing marital settlement terms which are referred to but not merged in the divorce decree, including both formal separation agreements and writings which lack characteristics of a contract, such as a letter. In order for an instrument to be considered "incident to divorce," the writing must provide adequate proof of the existence of a contract between the parties and it must memorialize the parties' understanding regarding the payment terms. I.R.C. § 71(b)(2)(A), Brooks v. Commissioner, T.C. Memo. 1983-304.

c. A written separation agreement in divorce practice ordinarily embodies a declaration of separation, the terms of the marital separation, and payment of support and division of marital property.

(1) Neither the Tax Code, nor the Treasury Regulations define "written separation agreement" for alimony purposes. Jacklin v. Comm'r, 79 T.C. 340, 346 (1982); Leventhal v. Comm'r, T.C. Memo. 2000-92; Keegan v. Comm'r, T.C. Memo. 1997-359.

(2) As construed by the IRS and the Tax Court, a separation agreement under I.R.C. § 71(b)(2)(B) need not be legally enforceable so long as it is entered "in contemplation of separation status" and entails a meeting of the minds on the payment terms. Bogard v. Comm'r, 59 T.C. 97 (1972); Treas. Reg. § 1.71-1(b)(2)(I); Richardson v. Comm'r, 97-2 U.S.T.C. Para. 50,653 (7th Cir. 1997), (cash payments made pursuant to separation agreement later determined to be unconscionable and therefore unenforceable are taxable alimony to payee spouse regardless of the state court's reason for invalidating the agreement).

d. Payments made merely to comply with a service regulation (e.g., AR 608-99) are not pursuant to a qualifying instrument and are not alimony.

e. If made under a decree of divorce or separate maintenance, the payment must be made after the decree (Treas. Reg. § 1.71-1(b)(1)). If made under a separation agreement, the payment must be made after the execution of that agreement (Treas. Reg. § 1.71-1(b)(2)).

3. The divorce or separation instrument must not designate that the payments will not be includable in the gross income of the recipient.

a. A taxpayer and spouse may designate that otherwise qualifying payments are not alimony. This is done by including a provision in the divorce or separation instrument that states the payments are not deductible by the taxpayer and are excludable from the spouse's income.

b. However, if a divorce or separation instrument designates a payment that would otherwise qualify as alimony as not to be treated as alimony (e.g., as a property settlement), the payment will not qualify as alimony. I.R.C. § 71(b)(1)(B).

c. Case Example: A taxpayer was divorced in Virginia and part of the settlement required him to provide his ex-spouse with 37.5% of his military retirement. Both parties were denied spousal support. Husband separated from the U.S. Navy and received a lump sum separation payment in lieu of retirement benefits. The ex-spouse petitioned a court in Illinois, where the husband resided to enforce the Virginia order. The IRS determined the payment was not an alimony payment and the husband could not deduct the payment. Generally, alimony is deductible to the extent the alimony is includable in the former spouse's gross income. However, both the Virginia decree and the Illinois order clearly contemplated that this payment was not to be alimony since neither party was to receive spousal support and the payment was to be a non-taxable event. Maloney v. Comm'r, T.C. Memo 2000-214, 2000 Tax Ct. Memo LEXIS 255.

4. There must be no requirement that payments continue beyond the death of the payee spouse (e.g., to the estate) or that any substitute payment is made after the death of the payee spouse (I.R.C. § 71(b)(1)(D)).

a. Payments must end at death of the payee spouse. This requirement is to discourage classification of large cash settlements in payment for marital property as deductible alimony.

(1) Case Example: Settlement agreement provided that taxpayer would pay certain sum for 142 payments without regard to death of payee spouse. Court looked to state law which did not help. Liability to make payments must terminate at the death of the payee spouse in order for such payments to be alimony. If a payor spouse continues to be liable to make even one otherwise qualifying payment after the death of the payee spouse, none of the related payments required before the payee spouse's death will be alimony. Cunningham v. Comm'r, T.C. Memo. 1994-474, 1994 Tax Ct. Memo LEXIS 482; (Treas. Reg. § 1.71-1T(b), Q & A-13.

(2) Will not be considered alimony if the payments do not meet the requirement of I.R.C. § 71(b)(1)(D), that the payments not extend beyond the death of the payee spouse. Stokes v. Comm'r, T.C. Memo. 1994-456, 1994 Tax Ct. Memo LEXIS 461.

b. To make sure of alimony treatment, the divorce or separation instrument should specify that otherwise qualifying payments will cease at the death of the recipient.

c. While alimony payments must terminate at the death of the payee, I.R.C. § 71(b) does not require that payments terminate at the death of the payor. If the payor's estate is required to continue alimony payments after the payor's death, the estate is not entitled to an alimony deduction for the payment. However, under I.R.C. § 682(b), such payments are treated as distributions to an estate beneficiary subject to the normal estate distribution rules. If the estate has distributable net income, the estate can take a deduction for the distribution and the payment is included in the payee's income as a distribution from the estate.

5. Payments must not be made during a tax year for which the payor and payee file a joint return. I.R.C. § 71(e).

6. Payments must not be to a member of the same household after a decree of divorce or separate maintenance has been issued or it will not be treated as alimony (I.R.C. § 71(b)(1)(C)). However, if spouses are not legally separated, a payment under a written separation agreement or temporary support order may be alimony even if they are members of the same household (Treas. Reg. § 1.71-1T(b), Q&A-9); Benham v. Comm'r, T.C. Memo. 2000-165 (May 22, 2000).

   a. Spouses will not be treated as members of the same household if one spouse is preparing to leave it, and does leave within one month after the payment.

   b. Coltman v. Comm'r, 980 F.2d 1134 (7th Cir. 1992), aff'd 1991 Tax Ct. Memo LEXIS 146, court applied Treas. Reg. § 1.71-1(b)(3)(i) and held that husband who used suburban marital home as part-time way station between his business and his real residence in another city, where he lived with "significant other" for most of the week, was not entitled to "alimony" deduction for payments to the former wife.

E. Payments may be made to a third party if spouse consents or instrument specifically calls for the third-party payment. I.R.C. 71(b)(1)(A). These can include payments for spouse's living expenses, food, clothing, insurance, medical expenses, housing costs, taxes, tuition, vacations, etc. The payments are treated as received by the spouse and then paid to the third party. Temp. Treas. Reg. § 1.71-1T(b)(Q & A-6); Priv. Ltr. Rul. 87-10-089.

1. Payments to third parties encompass payments to third parties made pursuant to a written request, consent or ratification of the payee. The qualifying instrument or writing must declare the parties' intent that the payment be treated as alimony subject to the rules of I.R.C. § 71 and must be received by the payor spouse prior to the date of filing his or her income tax return for the taxable year in which the payment is made. Treas. Reg. § 1.71-1T(b), Q&A-7.

2. However, payments made to maintain property owned by the payor spouse but used by the payee spouse (including mortgage payments, realty taxes, and insurance premiums) are not payments on behalf of the payee spouse (i.e., not alimony) even if made under the terms of the divorce or separation instrument. Treas. Reg. § 1.71-1T(b)(Q&A-6).

3. A payor spouse who is required by the divorce or separation instrument to pay the mortgage on a home he owns jointly with the payee spouse may deduct one-half of those payments as alimony, if they otherwise qualify (the rest may be deductible as qualified residence interest if paid on a qualified home).

4. The Tax Court has held that a man may deduct as alimony one-half of the housing payments he made "on behalf of" his wife, finding that letters qualified as a written separation agreement. Leventhal v. Comm'r, T.C. Memo. 2000-92 (2000).

5. Be careful of disguising child support as alimony. Payments which are for specific expenses of children as they arise may be considered child support and not alimony. Preston v. Comm'r, 2000 U.S. App. LEXIS 7190 (April 20, 2000).

F. Premiums a taxpayer must pay under a divorce or separation instrument for life insurance on their life qualify as alimony to the extent the spouse owns the policy. Temp. Treas. Reg. § 1.71-1T(b).

G. Compliance Provisions.

1. Recipient must furnish taxpayer ID number to payor. I.R.C. § 215(c).

2. Payor must include recipient's number on return. I.R.C. § 215(c).

3. Separation agreements should include parties' social security numbers (see sample provision, Appendix C, clause 3).

H. Child Support is not Alimony.

1. Payments specified in a divorce decree or separation agreement as child support are **not** includable in gross income.

2. Child support payments are **not** deductible by payor.

I. Unallocated Family Support.

1. If the amount of child support is not specified in the instrument, the amount to be decreased upon a contingency relating to a child will be treated as child support. I.R.C. § 71(c) reversed the rule found in Comm'r v. Lester, 366 U.S. 299 (1961); *see* Kean v. Comm'r, 407 F.3d 186, 190 (3d Cir. 2005). Contingencies relating to a child include reaching the age of majority, marriage, death, earning specified income level, gaining employment, and leaving the home of custodial parent.

Example: Separation agreement provides that H shall pay $500 per month for family support (unallocated). This amount shall be reduced by $50 per week per year when H has uninterrupted visitation with the child. Amount of the reduction ($50 is treated as fixed for child support. Total of $2,600 ($50 X 52 weeks) does not qualify as alimony (Priv. Ltr. Rul. 8746085).

XI. INDIVIDUAL RETIREMENT ACCOUNTS (IRA) WILL BE DISCUSSED IN SEPARATE CLASS.

XII. STUDENT LOAN INTEREST DEDUCTION. (I.R.C. §§ 62(A)(17) & 221)

A. For 2016, taxpayers are entitled to an adjustment to income (i.e., an above the line deduction) for interest paid on qualified educational loans. A loan and any refinancing of that loan are treated as one loan. Treas. Reg. §1.221-1(e)(3)(v)(A).

B. The maximum deduction allowed in 2016 is $2,500. (I.R.C. § 221(b)(1)). This is $2,500 per tax return – not per student or per taxpayer.

C. For 2016, the deduction phases out ratably for taxpayers with modified AGI between $65,000 and $80,000 ($130,000 and $160,000 for joint returns). I.R.C. § 221(b)(2)(B).

D. Modified Adjusted Gross Income for purposes of this section. AGI, as determined on Form 1040, before taking any deduction for student loan interest or qualified tuition and fees and modified by adding back the following:

1. Foreign earned income of U.S. citizens or residents living abroad.

2. Housing costs of U.S. citizens or residents living abroad.

3. Income from sources within Puerto Rico, American Samoa, Guam, or the Northern Mariana Islands. I.R.C. § 221(2)(C).

E. The student loan interest deduction may be claimed only by a taxpayer that is legally obligated to make the interest payments pursuant to the terms of the loan. Treas. Reg. § 1.221-1(b)(1).

F. An eligible student is one who:

1. Is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad that is approved for credit by the institution at which the student is enrolled) leading to a recognized educational credential at an eligible education institution, and

2. Is carrying at least one-half the normal full-time workload for the course of study the student is pursuing. I.R.C. § 221(d)(3); Treas. Reg. § 1.221-1(f)(3)(i)(C).

G. A person who is claimed as a dependent on another's tax return cannot claim the education interest deduction (I.R.C. § 221(c)).

H. Married couples must file joint returns to take the deduction (I.R.C. § 221(e)(2)).

I. A qualified higher education loan is any debt incurred to pay qualified higher education expenses that are:

1. Incurred on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the debt is incurred, (I.R.C. § 221(d)(1)(A)).

2. Paid or incurred within a reasonable period of time before or after the debt is incurred (90 days before or after the academic period), (I.R.C. § 221(d)(1)(B)) and

3. Attributable to education furnished during a period when the recipient was an eligible student (at least half-time student) (I.R.C. § 221(d)(1)(C)).

J. A qualified education loan includes debt used to refinance debt that qualifies as a qualified education loan, but does not include debt owed to a related person as defined by I.R.C. § 267(b).

K. A revolving line of credit will qualify as an education loan only if the borrower agrees to use it only for qualified higher education expenses.

L. Qualified higher education expenses are the costs of attendance at an eligible educational institution, which is generally a post-secondary educational institution eligible to participate in the federal student loan program. An eligible educational institution also includes one conducting an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility which offers postgraduate training (I.R.C. § 221(d)(2); Treas. Reg. § 1.221-1(e)(1)).

M. Qualified higher education expenses include tuition, fees, room and board, and related expenses, but must be reduced by the amount excluded by reason of such expenses under the rules for employer-provided educational assistance benefits, income from U.S. Savings Bonds used to pay higher education expenses, distributions from an education IRA, Veteran's Benefits, and scholarships or fellowship grants (I.R.C. § 221(d)(2), Treas. Reg. § 1.221-1(e)(2)).

N. No deduction is allowed under this section for any amount for which a deduction is allowable under any other provision of the Code (such as a home equity loan) (I.R.C. § 221(e)(1)).

O. In order to claim the student loan interest deduction, the taxpayer must complete the worksheet located in the tax form instructions and enter the allowable amount on Form 1040, line 33.

XIII. TUITION AND FEES DEDUCTION (I.R.C. §222, FORM 8917).

A. H.R. 5771 passed December 19, 2014 which extended the Tuition and Fees Deduction for tax year 2014. This deduction allows eligible taxpayers to claim an above the line deduction for qualified higher education expenses. However, the Tuition and Fees Deduction expired on 31 December 2014 and was extended through 2016 by S. 1946 – Tax Relief Extension Act of 2015. The deduction is now available for tax year 2016 only unless an extension is passed for 2017.

XIV. ADJUSTED GROSS INCOME.

A. Add all adjustments on Form 1040.

B. Subtract the total adjustments from the total income.

C. Enter the result on front of Form 1040. This amount is the adjusted gross income and is often referred to as "AGI." The AGI is the last line on the front of the Form 1040, and it is also carried over to the back of the Form 1040.

D. Adjusted gross income is used to compute some limitations, such as the medical and dental deduction on Schedule A and the credit for child and dependent care expenses.

XII. CONCLUSION.

CHAPTER H

TAX ASPECTS OF INDIVIDUAL RETIREMENT ACCOUNTS

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. IRS Tax Forms: 1040, IRA Deduction Worksheet, 8606, 5329, 5498.

B. Internal Revenue Code, 26 USC 408 and 408A and 219.

C. Federal Income Tax Regulations, 1.408-1 to 1.408-11 and 1.408A-0 to 1.408A-9.

D. IRS Publication 590, Individual Retirement Arrangements (IRAs).

II. FUNDAMENTALS.

A. Definition.

1. In general, an IRA is a trust or custodial account created or organized in the U.S. for the exclusive benefit of an individual or his or her beneficiaries (I.R.C. § 408(a); Treas. Reg. § 1.408-2(b)).

   a. Beneficiaries--the individual's estate, dependents, and any person he or she designates to share in the benefits of the account after death (Treas. Reg. § 1.408-2(b)(8)).

   b. IRAs are exempt from federal income tax unless the IRA is disqualified due to a prohibited transaction.

B. Characteristics.

1. Simple procedure for establishing personal retirement program.

2. Contributions to traditional IRAs are currently deductible, except by "active participants" in retirement plans who have adjusted gross income in excess of specified levels.

3. Earnings on traditional IRAs are not subject to federal income tax until distributed.

4. Roth contributions are not currently deductible. However, earnings are not subject to federal income tax upon qualified distributions.

C. Contribution Deadline. Normally the due date for the return (15 April without regard to extensions); however, the IRA need not actually be established until such due date in order to claim a contribution (I.R.C. § 219(f)(3)).

1. Contribution may be deducted if it is mailed before the return due date, even if it is not received by the IRA custodian until after the due date.

2. Deduction may be claimed on return--even if contribution not yet made--so long as contribution actually occurs by due date.

3. The CZ/QHDA extension provides service members with an additional period in which to contribute to an IRA for a preceding tax year (I.R.C. § 219(f)(7)).

a. To qualify, the service member must make a contribution before the <u>earlier</u> of the end of the income tax return filing period established under the CZ/QHDA tax extensions or the date on which the federal income tax return actually is filed. I.R.C. § 7508.

b. For example, a contribution made on June 1, 2015, could be designated as a contribution for the 2014 tax year if it is made before the taxpayer's CZ/QHDA suspension period expires. The taxpayer would have to designate the contribution as a contribution for the 2014 tax year to claim it on his or her 2014 income tax return.

c. For information on CZ/QHDA and IRA contributions *see* www.irs.gov. Pub 3, Armed Forces Tax Guide, and IR 2006-129 on the Hero Act.

D. Prohibited Transactions.

1. Borrowing money from an IRA. The amount borrowed is treated as a distribution.

2. Selling property to an IRA.

3. Pledging an IRA account as security for a loan. The part of the account pledged as security is treated as a distribution.

III. WHO MAY PARTICIPATE?

A. Taxpayer must have **earned** compensation.

1. Includes wages, salaries, tips, bonuses, commissions, partnership, alimony, self-employment income, and other amounts for personal services. **Only compensation includible in gross income is earned.** I.R.C. § 219(f).

2. Does not include passive income such as profits from property, i.e., rental income, interest, dividends, pensions, or annuities (including military retirement pay).

3. Compensation also does not include foreign earned income excluded from gross income.

B. Limits on IRA Contributions.

1. For 2016, the maximum annual contribution (to either traditional or Roth IRAs) is $5,500, I.R.C. § 219(b)(5). This is the same limit in 2015. The Pension Protection Act of 2006 (109 P.L. 280) makes these increased contribution limits permanent, including allowing for inflation adjustment after 2009.

2. An individual age 50 or older can make an additional $1,000 "catch up" contribution. I.R.C. § 219 (b)(5). The Pension Protection Act of 2006 makes catch-up contributions permanent. Catch up contributions are permitted beginning in the year the individual turns 50 and every year thereafter.

3. There are special rules for certain married individuals, which allow for a spousal IRA. A spouse with no earned compensation or amounts less than $5,500 can participate in an IRA. I.R.C. § 219(c). These special rules for spouses will be discussed in detail later in the outline.

IV. LIMITS ON TRADITIONAL IRA DEDUCTIONS (ADJUSTMENT TO INCOME).

A. Full deduction of contribution amount up to $5,500 ($6,500 if 50 or older) allowed **if** taxpayer is not covered by employer-provided retirement plan and earns at least $5,500 ($6,500 if 50 or older).

B. Limitations for Participants in Employer-Provided Retirement Plans for Traditional IRAs.

1. The Tax Reform Act of 1986 established limits on the deductibility of contributions by taxpayers covered by an employer-provided retirement program.

2. One is considered covered by an employer-provided plan even though the plan has not vested.

3. Active duty service members are considered covered by an employer-provided retirement plan (I.R.C. § 219(g)(1); IRS Notice 87-16; Morales-Caban v. Commissioner, T.C. Memo 1993-466; 1993 Tax Ct. Memo LEXIS 476 (active duty military covered by employer-provided plan).

4. Members of the reserve components who are not on active duty for over 90 days are not, by virtue of their reserve status, considered covered by an employer-provided plan. I.R.C. § 219(g)(6)(A).

C. Taxpayers with an AGI less than the applicable amount are permitted a full deduction. (See chart).

CAN YOU TAKE AN IRA ADJUSTMENT?

Table 1-2. **Effect of Modified AGI[1] on Deduction if You Are Covered by a Retirement Plan at Work**

If you are covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is ...	**AND** your modified adjusted gross income (modified AGI) is ...	**THEN** you can take ...
single or **head of household**	$61,000 or less	a full deduction.
	more than $61,000 but less than $71,000	a partial deduction.
	$71,000 or more	no deduction.
married filing jointly or **qualifying widow(er)**	$98,000 or less	a full deduction.
	more than $98,000 but less than $118,000	a partial deduction.
	$118,000 or more	no deduction.
married filing separately[2]	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

D. IRA deductions may be limited if the taxpayer is covered by an employer-provided retirement plan (e.g., service members).

1. Phaseout of deduction depends on income and filing status (I.R.C. § 219(g)(2)(A)).

a. Deduction Phaseout. The deduction is reduced or eliminated entirely depending on the taxpayer's filing status and income.

b. Computing the deductible amount:

STEP 1: Select the appropriate amount: $71,000 (if the taxpayer is single or head of household); or $118,000 (if taxpayer is married filing jointly or a qualifying widow(er); or $10,000 (if taxpayer is married filing separately). **STEP 2:** Subtract your Modified Adjusted Gross Income (MAGI) from the amount determined in Step 1. [**NOTE:** If the amount computed equals or exceeds $10,000, the taxpayer can make a fully deductible IRA contribution. If MAGI is greater than the amount in Step 1, the taxpayer cannot make a deductible IRA contribution.] **STEP 3:** Multiply Step 2 amount by .20. This is the taxpayer's maximum deductible amount (NOTE: The amount deductible is also limited by your compensation and by the amount that you actually contributed). If the result is not a multiple of $10, increase to the next highest $10. If the result is less than $200, taxpayer may still deduct $200 provided taxpayer contributes at least $200.

c. Use the worksheet in the Form 1040 Instruction booklet to figure the amount, if any, of the taxpayer's IRA deduction.

2. Taxpayers may make **nondeductible** contributions to the extent a deduction is disallowed. Must be reported to the IRS on Form 8606.

E. Special rules for married taxpayers.

1. There are special rules for certain married individuals that allow a taxpayer with no earned compensation or amounts less than $5,500 to participate in an IRA (I.R.C. § 219(c)). This section is not specifically for non-working spouses.

a. An individual who files a joint return and has less taxable compensation than his spouse may contribute to a spousal IRA and deduct the lesser of $5,500, or the sum of that individual's includible compensation for that tax year, plus the includible compensation of the individual's spouse reduced by the spouse's allowable IRA deduction and Roth IRA contribution for that tax year. I.R.C. § 219(c), (f).

b. A spouse who is 50 or older can also make the catch-up contribution of an additional $1,000.

c. The practical application of this provision permits IRA contributions (and perhaps a deduction) of up to $5,500 for each spouse (including a spouse with no compensation or less than $5,500 of compensation for the year) if their combined compensation income for the year equals or exceeds the contributed amount.

d. Total contributions to both are limited to $11,000 ($13,000 if both is 50 or older). The maximum contribution to either spouse's IRA is limited to $5,500 ($6,500 if 50 or older).

2. The phase-out limit is higher than the usual limit for an individual who is not an active participant in an employer plan during any part of the year, but whose spouse is an active plan participant. I.R.C. § 219(g)(7). For these individuals, the IRA deduction phase-out begins at $183,000 AGI, and it is eliminated at $193,000 AGI or more.

F. The HERO Act. Heroes Earned Retirement Opportunities Act (109 P.L. 227) was signed 29 May 2006. This Act addresses the problem of military members serving in CZ/QHDAs losing the opportunity to contribute to IRAs.

1. The HERO Act amends I.R.C. § 219 to include combat zone tax excluded income for purposes of eligibility for IRA contributions.

2. Contributions to a Roth IRA need not be reported. However, contributions to a traditional IRA must be reported on the appropriate year's tax return. Some service members will need to file an amended tax return if they had already filed for that tax year and some will just need to file the Form 8606.

3. Any time you make an IRA contribution, especially when intended for a different year, clearly annotate the contribution year in either a letter or on the check.

G. Nondeductible Contributions.

1. An active participant in a qualified plan who may not be eligible to make contributions either whole or in part to an IRA can make designated nondeductible contributions to an IRA for a tax year up to the due date for the income tax return for that year. Taxpayers who have lost part or all of their IRA deduction because of the phaseout rules may make nondeductible contributions to the extent the deductible amount is disallowed. I.R.C. § 408(o)

2. None of the earnings on the contributions will be taxed until distributed.

3. A taxpayer may designate deductible contributions as nondeductible. Nondeductible and deductible contributions can be made to the same IRA. I.R.C. § 408(o)(2)(B)(ii).

4. Taxpayers must report nondeductible contributions on IRS Form 8606.

   a. Failure to file form is subject to a $50 fine, unless reasonable cause is shown.

   b. Overstating nondeductible contributions carries $100 penalty, unless reasonable cause is shown.

5. A taxpayer making nondeductible contributions to a traditional IRA will have a cost basis in the IRA which is the sum of the nondeductible amounts that have been contributed less any distributions of those amounts.

H. Other Restrictions.

1. For traditional IRAs, no deduction is allowed for contributions for the benefit of an individual for the tax year he attains age 70 ½ or any later year. I.R.C. § 219(d)(1).

2. No deduction is permitted for a rollover contribution nor for any contribution to an "inherited" IRA—one acquired by other than the surviving spouse as a result of the death of the participant. I.R.C. § 219(d)(2).

I. Excess Payments and Contributions. I.R.C. § 4973.

1. These rules apply to Traditional IRAs and Roth IRAs.

2. An excess payment is defined as any amount paid into an account by the taxpayer, spouse, or employer exceeding the maximum amount (the taxpayer's taxable compensation or $5,500, $6,500 if over age 50).

3. Taxpayers must pay a 6% excise tax each year on the excess amount left in an account (unless withdrawn before the filing deadline).

4. Interest earned on excess payment generally must also be withdrawn and included in gross income, and is subject to a 10% tax for early withdrawal.

5. A taxpayer cannot reduce an excess payment by applying it against an earlier year in which less than the full amount was contributed. If contributed during the next year, the taxpayer can reduce the contribution by applying it against the next year, but the annual contribution limit may not be exceeded.

V. ROLLOVERS.

A. General Rule. I.R.C. § 408(d)(3).

1. Taxpayers may withdraw part/all funds in one IRA account and transfer to another IRA account, or (beginning in 2002) to a qualified retirement plan, within <u>60 days of withdrawal</u>, without tax liability. I.R.C. § 402(c).

a. Amount withdrawn is not considered an early withdrawal.

b. The 60-day period is strictly construed. PLR 8824047 (Rollover into another IRA not tax free even though failure to meet 60 day period was not taxpayer's fault). PLR 9211035 (Clerical error did not save taxpayer from tax). But see Wood v. Commissioner, 93 T.C. 114 (1989) (Trustee bookkeeping mistake not held against taxpayer).

c. If the rollover is not completed within the 60-day period, it is treated as a taxable distribution.

d. The IRS may waive the 60-day rollover period if failure to waive would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.

2. In general, a taxpayer may make only one tax-free rollover from an IRA to another IRA in any 12-consecutive month period (I.R.C. § 408(d)(3)(B)). If the taxpayer has more than one IRA, a separate one-year waiting period will apply to each such IRA.

Example: Captain R has two IRAs (IRA #1 and IRA #2). He rolls over the assets of IRA #1 into new IRA #3. Within the 12-consecutive month period commencing on the date of the distribution from IRA #1, he may also make a tax-free rollover from IRA #2 into IRA #3 or into any other IRA. However, he may not again, within such 12-consecutive month period, make a rollover from IRA #1. See IRS Pub. 590.

3. Inherited IRAs.

a. A surviving spouse , who is the **sole** designated beneficiary, who receives her interest in the IRA pursuant to inheritance may roll over a distribution from that IRA to another IRA, or to a qualified retirement plan of their own, without incurring tax liability. I.R.C. § 408(d)(3)(C).

b. A non-spouse beneficiary may not roll over post-death proceeds from an IRA. I.R.C. § 408(d)(3)(C).

(1) A non-spouse beneficiary, like the original owner, generally will not owe tax on the assets in the IRA until distributions from the IRA are received.

(2) There are special rules that apply to when non-spouse beneficiaries must withdraw IRA assets or take required distributions.

(3) If a taxpayer inherits a traditional IRA from a person who had a basis in an IRA because of nondeductible contributions, that basis remains with the IRA. If a taxpayer takes a distribution from an inherited IRA that has a basis, the taxpayer must complete a Form 8606 to determine the taxable and nontaxable portions of the distributions.

4. The distribution from an IRA to a spouse or former spouse pursuant to a "qualified domestic relations order" may be rolled over tax free to another IRA. However, if the alternate payee is not the IRA participant's spouse or former spouse, the distribution may not be rolled over. Specifically, the distribution to a non-spouse alternate payee is includible in the gross income of the IRA participant (I.R.C. § 402(e)(1)(B).

5. If an eligible rollover distribution is paid directly to the taxpayer, the payer must withhold 20% of it. This applies even if you plan to roll over the distribution to a traditional IRA. The taxpayer can avoid the withholding by choosing the direct rollover option.

6. Report rollovers (e.g., IRA distributions) on Form 1040, or Form 1040A.

B. Military Death and Servicemembers' Group Life Insurance (SGLI) Payments.

1. A recipient of a military death gratuity or SGLI proceeds can contribute the amounts received (reduced by any amounts contributed to a Coverdell education savings account) to a Roth IRA as a qualified rollover contributions. I.R.C. 408A(e)(2).

2. The requirement that only one tax-free rollover contribution can be made to a Roth IRA during any one-year period does not apply. I.R.C. 408A(e)(2)(B).

3. The rollover has to be made within one year of a receipt of payment. I.R.C. § 408A(e)(2)(A).

C. Exceptions.

1. Transfers directly from one trustee to another trustee are not rollovers and may be made at any time.

2. The transfer of an individual's interest in an IRA pursuant to a divorce decree or instrument incident to a divorce decree is not considered a taxable transfer or distribution (I.R.C. § 1041).

a. Must be received within one tax year.

b. Must roll into another IRA.

VI. TAX TREATMENT OF TRADITIONAL IRA DISTRIBUTIONS.

A. Distributions are included in gross income and reported to the taxpayer on Form 1099-R. I.R.C. § 408(d). The taxpayer reports total IRA distributions on line 15a and total taxable distributions on line 15b of Form 1040.

B. Nondeductible contributions are not taxed when distributed.

1. Taxpayer has cost basis in the IRA on investment.

2. Earnings on nondeductible contributions are taxed when distributed.

3. Special accounting is required to compute tax on distributions if both deductible and nondeductible contributions were made.

4. Losses on IRA investments recognized only when entire IRA distributions are made.

C. Premature Distributions.

1. Taxpayer includes distributions received before age 59 ½ in gross income (Form 1040, line 15). In addition, the taxpayer must pay a 10% additional tax. Withdrawals before age 50 ½ are called premature or early withdrawals. This tax is 10% of the part of the distribution that the taxpayer must include in gross income. (Form 1040, line 58; Form 5329).

2. There are a number of exceptions to the 10% penalty:

   a. The receipt of a distribution from a traditional IRA that includes a return of nondeductible contributions is not subject to the 10% penalty.

   b. The 10% penalty does not apply if taxpayer dies, or becomes disabled. I.R.C. § 72(t)(3)(A).

   c. The 10% additional tax also does not apply to any "qualified reservist distribution" made to individuals ordered or called to active duty for more than 179 days (or an indefinite period) after 11 September 2001. I.R.C. § 72(t)(2)(G)(i).

   d. Unemployed individuals: To the extent that they do not exceed qualifying medical insurance premiums, distributions by an IRA to certain unemployed individuals are not subject to the 10% penalty. I.R.C. § 72(t)(2)(D).

   e. Qualified higher education expenses: The 10% penalty will not be charged if the individual uses the IRA money to pay for qualified higher education expenses for the individual, the spouse, child, or grandchild of the individual or their spouse. Qualified expenses are defined the same as for section 529(e)(3). I.R.C. § 72(t)(2)(E).

   f. First-time homebuyer expenses: The 10% penalty will not be charged if the individual uses the IRA money for certain expenses associated with buying a principal residence. Only $10,000 during the individual's lifetime may be withdrawn without a penalty for this purpose. I.R.C. § 72(t)(2)(F).

      (1) Qualified expenses include acquisition costs, settlement charges and closing costs.

(2) The principal residence may be for the individual or the individual's spouse, child, grandchild, or ancestor.

(3) To be considered a first-time homebuyer, the individual must not have had an ownership interest in a principal residence during the two-year period ending on the date that the new home is acquired.

g. Annuity exception - taxpayer may receive distributions without penalty if distributions are part of a series of substantially equal payments over taxpayer's life, even if taxpayer is less than 59 and 1/2. Two special requirements:

(1) At least 1 distribution annually, and

(2) Distribution payments continue for at least 5 years or until taxpayer reaches 59 and 1/2, whichever is longer.

h. If a taxpayer made a contribution to an IRA during the tax year and withdraws the money before the due date of the tax return, then he will not be subject to the 10% penalty. If a taxpayer has an extension of time to file a tax return, then the taxpayer can withdraw the money from the IRA tax-free by the extended due date. However, the taxpayer must also withdraw any interest or other income earned on the contributions and include that in income.

D. Taxpayers receiving premature distributions must complete IRS Form 5329 and enter the amount of the tax on Form 1040, line 58.

E. Required Minimum Distributions (RMD) for Traditional IRAs.

1. Taxpayers must begin receiving distributions by April 1 of the year after they reach 70 1/2. For all subsequent years, they must receive distributions before December 31.

2. The rules for a RMD:

a. During the IRA owner's lifetime, RMDs from the IRA account are paid over the owner's life expectancy as determined in the Uniform Life Table.

b. If the IRA owner is married to someone who is more than 10 years younger, the IRA owner may elect to take RMDs based on the Joint and Last Survivor Table **IF** the younger spouse is the only beneficiary to the IRA.

c. RMD is determined by dividing the balance of the IRA on 31 December of the year previous to the year of distribution by the number on the appropriate table.

3. Post-death rules for RMD.

a. First must determine if there is a designated beneficiary. Under the new rules, who the designated beneficiary is must be determined NLT 30 September of the year following the year of the owner's death.

b. The determination is based on who was named as a beneficiary before the owner's death and whether any such beneficiary has disclaimed an interest or "cashed out" his benefit by that date.

c. If benefits are payable to the owner's estate or to a charity, then there is no designated beneficiary for RMD purposes. (This results in the proceeds of the IRA having to be completely disbursed NLT the end of the 5th year following the death of the owner if the owner died before required beginning date **OR** over the owner's remaining life expectancy (as of the year of death) if he died after the required beginning date.

d. Rules if the IRA owner dies before the beginning date.

(1) No designated beneficiary: The IRA balance must be distributed in full NLT than the end of the fifth year following the year of death. This is automatically applied, and there is no exception.

(2) Designated beneficiary: The beneficiary takes an RMD based on his life expectancy using the Single Life Table (the IRA custodian may allow the beneficiary to elect the 5 year rule).

e. Rules if the IRA owner dies on or after the beginning date.

(1) No designated beneficiary: The RMD is figured based on the owner's life expectancy under the Uniform Life Table using the owner's age on his birthday during the year of death.

(2) Designated Beneficiary: The RMD is based on the beneficiary's life expectancy using the Single Life Table. (The beneficiary may elect to take the RMD over the owner's remaining life expectancy)

f. IRA with multiple beneficiaries. The account can be divided into separate accounts for each beneficiary to enable each beneficiary to take distributions over their own life expectancy. If it is not split, then the distributions are determined over the life expectancy of the oldest beneficiary. The separate account must be established NLT the end of the year following the year of death of the owner.

4. Taxpayers have to pay a 50% excise tax on the excess amounts left in IRAs for any year that a RMD is not taken or not taken in full

VII. ROTH IRA.

A. A Roth IRA is an IRA that is designated as a Roth IRA when it is established. I.R.C. § 408A(b). It is treated as a regular IRA except to the extent that special rules apply to it. I.R.C. § 408A(a).

B. Same contribution rules as traditional IRA, the lesser of compensation or $5,500 a year to a Roth IRA. Contributions are nondeductible (I.R.C. § 408A(c)(1)), but qualified distributions are not taxable and are not included in income. I.R.C. § 408A(d)(1)(A).

1. Individuals age 50 or older can contribute an additional $1,000 "catch up" contribution to a Roth IRA.

2. The Roth IRA may be the best bet for military taxpayers who are subject to the phase out rules of the regular IRA.

C. Roth IRA contributions for a year must be made by April 15th of the following year. I.R.C. § 408A(c)(7).

D. Unlike traditional IRAs, contributions are permitted after age 70 ½. I.R.C. § 408A(c)(4).

E. Total contributions to Traditional and Roth IRAs cannot exceed $5,500 per taxpayer, or $6,500 if over the age of 50. I.R.C. § 408A(c)(1).

F. The phaseout amounts for being able to contribute to a Roth IRA in 2016 are:

1. AGI $183,000 to $193,000 for taxpayers filing a joint return.

2. AGI $116,000 to $131,000 for any other taxpayer other than a married individual filing a separate return.

3. AGI $0 to $10,000 for a married individual filing a separate return.

4. AGI for this purpose does not include income resulting from the rollover or conversion from a regular IRA to a Roth IRA. I.R.C. § 408A(c)(3).

5. AGI based contribution limits for Roth IRAs apply whether or not the taxpayer is a participant in a qualified retirement plan.

G. Conversion of a Traditional IRA to a Roth IRA:

1. Beginning in 2010, the AGI limit was eliminated and a taxpayer can convert a traditional IRA to a Roth IRA regardless of their AGI.

2. The conversion is subject to federal income taxation as if it was not rolled over, <u>but it is not subject to the 10% penalty</u> (I.R.C. § 408A(d)(3)(A)(ii); I.R.C. § 408A(c)(3)(C)(i)).

3. If a taxpayer does so, the amount of money converted is included in his taxable income except to the extent that the regular IRA consisted of nondeductible contributions.

4. Individuals that have made nondeductible contributions to regular IRAs, the standard IRA basis recovery rules (requiring a prorated calculation) must be applied to determine the taxable amount of the transaction.

5. Conversions must be reported on Form 8606, even if the taxpayer elected in 2010 to report the tax in 2011 and 2012. The election to stretch out the tax owed is also made on the Form 8606.

6. Conversions made after 31 Dec 2010: Tax owed is due on the tax return and cannot be stretched over additional years.

7. Recharacterized Contributions.

   a. To provide relief for taxpayers who want to "undo" a conversion of an IRA to a Roth IRA or who want to change the nature of an IRA contribution, I.RC. § 408A(d)(6), allows taxpayers to treat the transfer of a contribution (or a portion of a contribution) from one type of IRA (the first IRA) to a different type of IRA (the second IRA), as though the original contribution had been made directly to the second IRA.

   b. In effect, the contribution is reversed (recharacterized) and it and any associated earnings or losses are transferred back to the original IRA. Treas. Reg. § 1.408A-5, Q&A-1(a), clarifies that redesignating the first IRA as the second IRA is treated as a transfer of the entire account balance from the first IRA to the second IRA. Regardless of the conversion method used, contributions not properly recharacterized may be subject to the I.R.C. § 4973 excise tax, under Treas. Regs. § 1.408A-4, Q&A-3(b).

   c. Only actual contributions can be recharacterized. Therefore, excess contributions made in a prior year and applied against the contribution limits in the current year under I.R.C. § 4973 cannot be recharacterized, unless the actual contribution still meets the recharacterization requirements.

d. Recharacterized contributions had to have been identified by 15 October of the year after the original conversion or contribution is made. In other words, transactions made in 2015 had to have been identified by 15 October 2016.

8. Reconversions.

a. A person who has converted an amount from a traditional IRA to a Roth IRA may not only transfer the amount back to a traditional IRA in a recharacterization, but may later reconvert that amount from a traditional IRA to a Roth IRA and, under certain circumstances, have the resulting income fixed at the time of the reconversion.

b. An IRA owner who converts an amount from a traditional IRA to a Roth IRA and then transfers that amount back to a traditional IRA by way of a recharacterization cannot reconvert that amount from the traditional IRA to another Roth IRA before the beginning of the tax year following the tax year in which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by way of a recharacterization.

c. The timing rule applies regardless of whether the recharacterization occurs during the tax year in which the amount was converted to a Roth IRA or the following tax year. Treas. Regs. Sec. 1.408A-5, Q&A-9, now provides rules for reconversions.

> Note: This restriction prevents a taxpayer from recharacterizing a Roth IRA as a traditional IRA if the market value of the IRA has been substantially reduced, e.g., because of a sharp decline in the market value of stocks held in the IRA , and then immediately reconverting to a Roth IRA to take advantage of the lower market value in determining the income to be reported from the conversion.

d. A reconversion made before the later of the beginning of the next tax year or the end of the 30-day period that begins on the day of the recharacterization is treated as a failed conversion, subject to correction through a recharacterization back to a traditional IRA.

(1) A failed conversion results in a distribution from the traditional IRA that is subject to tax (and possibly penalty tax) followed by a regular contribution to the Roth IRA.

(2) To the extent it exceeds the annual contribution limit, the amount treated as a regular contribution to the Roth IRA is treated as an excess contribution subject to the excise tax under I.R.C. § 4973. Treas. Reg § 1.408A-4, Q&A-3(b); Treas. Reg § 1.408A-4, Q&A-1(d); Treas. Reg § 1.408A-5, Q&A-9(a)(1).

(3) For purposes of the reconversion timing rules above, a failed conversion resulting from not having satisfied the statutory requirements is treated as a conversion in determining when an IRA owner may make a reconversion. Treas. Reg. § 1.408A-5, Q&A-9(a)(2).

9. What resources were used to pay the taxes?

a. A taxpayer electing to roll from a regular IRA to a Roth IRA must decide whether to take the resulting income tax from the distribution being received, while rolling the remainder to the Roth IRA. In the alternative, the taxpayer could pay the tax from another source.

b. If a taxpayer takes funds from the distribution to pay the tax, then that amount is ineligible for the special tax and penalty (10% penalty) treatment afforded rollovers to Roth IRAs.

10. If a taxpayer contributed money or made a contribution to a Roth IRA and later discovered their AGI for the year was too high or had second thoughts about the Roth contribution, then the taxpayer can move any contribution or rollover amount (plus attributable earnings) back from the Roth IRA to a regular IRA.

H. Distributions from Roth IRAs.

1. Qualified distributions from Roth IRAs are not included in income. I.R.C. § 408A(d)(1).

2. Qualified distributions are distributions made after the five-tax-year period beginning with the first tax year the taxpayer or the taxpayer's spouse made a contribution to a Roth IRA, including a qualified rollover contribution from an IRA other than a Roth IRA (I.R.C. § 408A(d)(2)), and that are made:

a. On or after attaining age 59½,

b. At or after death (to a beneficiary or estate),

c. On account of disability, or

d. For a first-time home purchase expense under I.R.C. § 72(t)(2)(F). *See* I.R.C. § 408A(d)(2)(A); I.R.C. § 408A(d)(5); Treas. Reg. § 1.408A-6, Q&A-1.

3. Roth IRAs are not subject to the required minimum distribution rules of I.R.C. § 401(a)(9)(A) or the incidental death benefit requirements of I.R.C. § 401(a). *See* I.R.C. § 408A(c)(5).

VIII. COVERDELL EDUCATION SAVINGS ACCOUNT (CESA) .

A. A CESA is a trust or custodial account established exclusively for the purpose of paying the beneficiary's qualified higher education expenses. I.R.C. § 530(b)(1); I.R.C. § 530(g).

B. Allowable annual contributions to CESAs are not deductible and are not taxable when withdrawn, but distributions of earnings from CESAs for qualified education expenses are tax-free

1. Contributions :

a. Must be (I.R.C. § 530(b)(1)(A)):

(1) Cash;

(2) Made before the beneficiary reaches the age of 18 (or at any age for a child with special needs); and

(3) Are limited to $2,000 for the taxable year (except in the case of rollover contributions).

(4) The American Taxpayer Relief Act of 2012 expanded the definition of education expenses to include elementary and secondary school expenses for taxable years beginning in 2013.

b. Contributions for tax year 2016 must be made by 15 April 2017, the same as with IRAs. I.R.C. § 530(b)(5).

c. The amount a taxpayer can contribute is phased out with incomes from $190,000 to $220,000 for taxpayers filing a joint return and $95,000 to $110,000 for all other taxpayers. I.R.C. § 530(c)(2). As a practical note, though, a low-tax-bracket grandparent or other person can contribute to a CESA for a beneficiary, even though the grandchild's parent is precluded from doing so (due to the parent's high income).

d. **No deduction is allowed for Coverdell ESA contributions**; however, the earnings are not subject to taxation while in the account. I.R.C. § 530(e).

e. There is no limit on the number of CESAs that can be established designating the same child as the beneficiary. However, total contributions for the child during any tax year cannot be more than $2,000. I.R.C. § 530(b)(1)(A)(iii).

f. Contributions may be made during the same year to both a CESA and an I.R.C. § 529 Qualified Tuition Program plan for the same student.

g. An individual who has received a military death gratuity or Servicemembers' Group Life Insurance (SGLI) payment can roll it over (contribute it) to one or more CESAs, without regard to the above annual contribution limit (I.R.C. § 530(d)(9)(A)) or the AGI phase-out limit.

(1) The contribution must be made before the end of the one-year period beginning on the date on which the contributor received the payment. I.R.C. § 530(d)(9)(A).

(2) The rule allowing only one rollover contribution to a CESA during any 12-month period does not apply to this rollover. I.R.C. § 530(d)(9)(B)).

2. Distributions are not included in gross income so long as they are used to pay for qualified education expenses. I.R.C. § 530(d)(2).

a. Qualified education expenses (I.R.C. § 530(b)(2)) include:

(1) Higher education tuition, fees, books, and supplies, certain room and board charges, as long as at least a half-time student (as defined in I.R.C. § 529(e)(3)); and

(2) Elementary and secondary public and private or religious school tuition and expenses, including tutoring, room and board, transportation, uniforms, an extended day programs; computer technology or equipment or expenses for internet access and related services for use by the beneficiary and his family during any of the years that the beneficiary is in school, but not expenses for computer software designed for sports, games, or hobbies unless it is predominantly educational in nature. I.R.C. § 530(b)(2)(A)(ii); § 530(b)(3).

b. If distributions are for any other reason, then they are subject to taxation in a manner similar to regular IRAs. They are also subject to a 10% penalty. I.R.C. § 530(d)(4)(A). There is no <u>penalty</u> for distributions (I.R.C. § 530(d)(4)(B)--

(1) made to a beneficiary or the estate of the beneficiary on or after the death of the designated beneficiary;

(2) attributable to the disability of the designated disability;

(3) made on account of a scholarship, allowance, or payment to the extent the distribution does not exceed the amount of the scholarship, allowance, or payment; or

(4) made on account of attendance at a military academy, to the extent that the distribution does not exceed the costs of advanced education.

3. Any account balance must be distributed within 30 days after the date the beneficiary reaches age 30 (unless the beneficiary has special needs), or if the beneficiary dies before reaching age 30, shall be distributed within 30 days after the day of death of the beneficiary. I.R.C. § 530(b)(1); I.R.C. § 530(d)(8).

4. Any amount distributed from a CESA and rolled over to another education IRA for the benefit of the same designated beneficiary or certain members of the designated beneficiary's family (spouse or child or a descendant of a child; brother, sister, stepbrother, or stepsister; father or mother, or an ancestor of either; stepfather or stepmother; son or daughter of a brother or sister of the taxpayer; brother or sister of the father or mother of the taxpayer; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law) is not taxable, as long as the new beneficiary is under age 30 on the date of the rollover contribution to the new ESA. I.R.C. § 530(b)(6).

5. The Hope, American Opportunity Tax Credit, and Lifetime Learning Credits may be taken in the same year that a tax-free ESA distribution for that student was taken. However, the expenses used to calculate the credit cannot include any expenses paid for by the ESA distribution. I.R.C. § 530(d)(2)(C).

C. There is no 6% excise tax on excess earnings if they are withdrawn before the beginning of the 6th month following the year of the contribution. For most, this means 31 May 2017 for excess contributions attributed to 2016.

IX. QUALIFIED TUITION PROGRAMS (529 PLANS).

A. A qualified tuition program is one established and maintained by a State or agency or instrumentality, and there are two types (I.R.C. § 529(a)):

1. Prepaid tuition program, where the contributor purchases tuition credits or certificates on behalf of a designated beneficiary, which entitles the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (I.R.C. § 529(b)(1)(A)(i)); and

2. Education investment plans, where the contributor deposits money into an account that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account (I.R.C. § 529(b)(1)(A)(ii)).

B. In general, no amount shall be includible in the gross income of a designated beneficiary under a qualified tuition program or a contributor to such a program. I.R.C. § 529 (c)(1). Additionally, there are no income restrictions on the individual contributors.

1. A contribution to a qualified tuition program shall be treated as a completed gift, but not as a qualified transfer for educational expenses (which are not treated as a transfer of property by gift). I.R.C. § 529(c)(2)(A). If the aggregate amount of contributions during a calendar year by a donor exceeds the annual gift tax exclusion, the donor may elect to take it into account as a gift ratably over a 5-year period. I.R.C. § 529(c)(2)(B).

2. Distributions are not included in income (I.R.C. § 529(c)(3)(B) as long as they do not exceed the qualified higher education expenses of the distributee.

a. Qualified higher education expenses are tuition, fees, books, supplies, and equipment <u>required for the enrollment or attendance of a designated beneficiary at an eligible education institution</u>; and expenses for special needs services for a special needs beneficiary, which are incurred in connection with such enrollment or attendance. I.R.C. § 529(e)(3)(A). Elementary and Secondary qualified expenses include expenses for tutoring, computer equipment and technology (including internet access) or related services, room and board, uniforms, transportation and supplementary items such as extended day programs as required and provided by the school.

b. Qualified higher education expenses for at least half-time students may also include the reasonable costs (as determined under the qualified tuition program) for room and board, but that amount shall not exceed the allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student **or** the actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

c. Expenses used to obtain the Hope, American Opportunity Tax Credit, and Lifetime Learning Credits may not be taken into account when determining qualified higher expenses for qualified tuition program distribution purposes. I.R.C. § 529(c)(3)(B)(v).

d. If the amount of distributions from Coverdell Education Savings Accounts (I.R.C. § 530) and Qualified Tuition Programs (I.R.C. § 529) exceed the amount of qualified higher education expenses taken into account in the current year, then the expenses shall be allocated between the two programs to determine the taxable amount. I.R.C. § 529(3)(B)(vi).

e. Change in beneficiaries or programs (I.R.C. § 529(c)(3)(C))

(1) Distributions are not taxable if they are transferred within 60 days of the distribution to another qualified tuition program for the benefit of the designated beneficiary or to the credit of another designated beneficiary who is a family member of the designated beneficiary with respect to whom the distribution was made.

(2) The designated beneficiary may be changed, as long as the new beneficiary is a member of the family of the old beneficiary.

f. An additional 10% penalty shall apply to distributions that are not used for qualified higher education expenses (the same as for Coverdell ESA distributions). I.R.C. § 529(c)(6).

g. A cash distribution that does not exceed the qualified higher education expenses (reduced by the in-kind expenses above) is not includible in the gross income of the distributee.

h. The Pension Protection Act of 2006 made permanent 529 plan upgrades that were part of the 2001 EGTRRA tax law.

X. CONCLUSION.

CHAPTER I
TAX ASPECTS OF STOCKS & MUTUAL FUNDS

I. REFERENCES.

A. IRS Tax Forms: 1040, 8949, Schedule A, B, D, 1099-DIV, 1099-B.

B. Internal Revenue Code (I.R.C.).

C. Federal Income Tax Regulations (Treas. Reg.).

D. IRS Publications:

1. Pub. 17, Your Federal Income Tax Guide.
2. Pub. 544, Sales and Other Dispositions of Assets.
3. Pub. 550, Investment Income and Expenses.
4. Pub. 551, Basis of Assets.

II. INTRODUCTION.

III. CAPITAL ASSET (I.R.C. § 1221).

A. Defined: any asset held whether connected with a trade or business except:

1. Inventory held in the ordinary course of business.

2. Depreciable property used in trade or business.

3. Property held primarily for sale to customers in ordinary course of business.

4. Copyrights, literary or musical compositions, memorandums.

5. Accounts receivable acquired in the ordinary course of business.

B. Examples. Almost everything the taxpayer owns is a capital asset, including:

1. Investment property (e.g., mutual fund shares, stocks, bonds).

2. Property held for personal use, such as a personal residence, jewelry, automobile used for pleasure or commuting, coin or stamp collections.

IV. SIGNIFICANCE OF CAPITAL ASSET CLASSIFICATION.

A. Maximum capital gains tax rate (I.R.C. § 1(h)).

1. 28%: Sales of collectibles.

2. 0%: For sales of property if taxpayer is subject to a tax rate less than 25%.

3. 15%: For sales of property if a taxpayer is in the 25% - 35% tax brackets

4. 20%: For sales of property if a taxpayer is in the 39.6% tax bracket.

5. Up to 25% for real estate recapture that is treated as capital gain.

6. Capital gains and losses are reported on Form 8949 (new for 2011 and beyond) and Schedule D.

B. Capital Gains Distributions.

1. Paid out of the net long-term capital gains of a corporation. Typically come from mutual funds, investment companies, or real estate trusts.

2. Capital gains distributions are reported to taxpayers on Form 1099-DIV, and by the taxpayer on Schedule D, line 13. The taxpayer then completes Schedule D to compute the net long-term capital gains or losses, and then computes the back of the schedule to determine the maximum capital gains tax.

3. If the only amount a taxpayer has to report on a Schedule D is a capital gain distribution, the taxpayer may be able to report that amount directly on Form 1040, line 13.

4. The 1099-DIV identifies in block 2a the total capital gain distributions.

C. Losses from the sale or exchange of assets held for personal pleasure are not deductible unless the loss resulted from a theft or casualty, in which case they may be deductible as ordinary losses (IRC § 165(c)).

V. BASIS.

A. Cost Basis. Usually basis is property's cost, including:

1. Amount of cash, and the fair market value of property or services exchanged;

2. Amount of debt, mortgage, or liability assumed; and

3. Purchase fees and closing costs (I.R.C. § 1012).

B. Other Basis.

1. Fair Market Value. The price at which a willing seller would sell and a willing buyer would pay for a piece of property, both acting at arms length, with full knowledge of the facts involved, and neither being under any compulsion to sell or buy.

2. Basis of gifts (I.R.C. § 1015).

a. General rule (GR): carryover basis.

b. Exception rule (ER): Basis will be fair market value (FMV) if basis is greater than FMV at time gift made and there is a loss on the sale of the property later by the donee. ER applies only if donor's basis is greater than FMV when gift made and donee's subsequent sale price is less than both donor's basis and FMV when gift made.

c. Examples:

Donor Basis	Gift FMV	Sale Price by Donee	Gain/ Loss	
$100	$ 90	$200	$100	(GR)
100	150	200	100	(GR)
100	150	90	(10)	(GR)
100	90	150	50	(GR)
100	90	80	(10)	(ER)
100	90	95	none	

3. Inherited property (I.R.C. § 1014). Fair market value at date of decedent's death or alternate valuation date.

Untaxed appreciation (i.e., increase in value of property above basis) avoids federal income taxation when property passes by inheritance. This means the heir could sell the property for its fair market value and not pay income tax on the total gain.

SUMMARY OF RULES ON BASIS

HOW PROPERTY OBTAINED	BASIS FOR DETERMINING GAIN	BASIS FOR DETERMINING LOSS
Gift	Donor's basis carried over (plus gift tax paid) but not more than fair market value at time of gift.	Donor's carryover basis (plus gift tax paid on appreciation for gifts post-1976), or fair market value at date of gift, whichever is lower.
Inherited	Fair market value at date of death, or value six months after death or at distribution within six months after death, if alternate valuation date elected.	Same as for gain.
Nontaxable Exchange	Basis of property acquired is basis of property given up, plus any recognized gain and less any cash received.	Same as for gain.

C. Adjusted Basis (I.R.C. § 1016).

1. The basis of property must be increased or decreased to reflect certain transactions. Events after purchase can necessitate adjustments to basis.

2. The term adjusted basis refers to the basis after changes are made.

3. Common basis increases:

   a. Capital expenditures/improvements (having a useful life of more than one year) add to the value of property, lengthen its life, or adapt it to a different use (e.g., adding a room to a home).

   b. Contributions to capital.

   c. Assessments paid for local improvements.

4. Common basis decreases:

   a. Partial losses due to theft or casualty. (Decreased by the amount of insurance or reimbursements received and the amount of deductible loss.) I.R.C. § 165(h).

   b. Depreciation. Basis is reduced by the larger of the:

      (1) amount claimed.

      (2) amount allowed (I.R.C. § 1016(a)(2)).

5. For example, when a stock dividend or stock split is declared, the stockholder receives additional shares of stock. Some of the basis from the original stock is then allocated to the new stock. This change reduces the basis per share of the original shares.

6. The adjusted basis of a stock is usually its cost plus any brokers' commissions.

VI. DETERMINING CAPITAL GAIN OR LOSS.

A. General Rule.

1. The gain or loss from a sale or other disposition of property is measured by the difference between the amount realized and the adjusted basis of property sold or exchanged (I.R.C. § 1001; Treas. Reg. § 1.1001-1).

2. The amount realized is the total of all money received, the fair market value of property or services received, plus any liabilities assumed by the buyer.

3. Gain from the sale or exchange of property is included in income and taxed at ordinary income tax rates, subject to certain maximum capital gains rates.

4. Report capital gains and losses on Schedule D, Form 1040.

B. Holding Period.

1. Whether gains or losses from the sale or exchange of capital assets are short-term or long-term depends on the period of time the capital assets were held.

a. Short-term is twelve months or less;

b. Long-term is over twelve months.

2. Records should show acquisition and disposition dates.

a. Exclude date property was acquired but include date it was disposed.

b. Day after property was acquired is start of holding period and this same date in succeeding calendar months is start of new month.

3. Stock splits and stock dividends:

a. Stock acquired in a tax-free stock dividend or stock split has the same holding period as the original stock owned.

b. If the original stock has a long-term holding period, stock received in a tax-free stock dividend also has a long-term holding period.

Example: T bought stock on 26 June 2013. He starts counting the holding period on 27 June 2013. T must sell on or after 27 June 2014 to have held it more than one year.

C. Net Capital Gains and Losses (Computing Capital Gains).

1. Short-term capital gain and loss means gain or loss from the sale or exchange of a capital asset held no more than 12 months.

2. Long-term capital gain and loss means gain or loss from the sale or exchange of a capital asset held more than 12 months.

3. Net capital loss is excess of all capital losses for the year over capital gains.

4. Net capital gain is the excess of net long-term capital gains over net short-term capital losses.

5. Determine whether any maximum tax rates apply.

D. Capital Losses.

1. Amount of loss deductible. A non-corporate taxpayer having capital losses may deduct those losses only to the extent of gains from the sale of capital assets plus the lower of:

a. $3,000 ($1,500 for married individuals filing separate returns), or

b. the excess of the losses over the gains (I.R.C. § 1211(b)).

2. Capital loss carryover. Losses in excess of the amounts deductible are carried over to the succeeding tax years indefinitely until absorbed (I.R.C. § 1212(b)).

3. Carryover capital losses retain their character as long term or short term. Short-term losses must be used first.

VII. BASIS OF STOCKS & BONDS.

A. If possible, trace basis of stock or bond sold to original cost.

B. If tracing is not possible, the cost of the first lot bought is used as the basis for the first lot sold (FIFO) (Treas. Reg. § 1.1012-1(c)).

C. Distributions.

1. Ordinary dividends.

a. Paid out of earnings and profits.

b. Cash or stock.

c. Taxable in year paid.

2. Capital gain distributions.

a. Paid out of net long-term capital gains of company.

b. Reported as long-term capital gain on Schedule D or directly on Form 1040, line 13.

c. Mutual funds, investment companies, real estate trusts pay them.

3. Nontaxable distributions.

a. Not paid out of earnings.

b. Return of investment.

c. Reduces basis to zero, then reported as either a long- or short-term capital gain depending on holding period.

d. If stock dividend is identical to the held stock, then divide adjusted basis of old stock by the number of old and new stock shares. For example, T holds one share of voting common at $60. The corporation distributes a stock dividend of two new shares of voting common for each share held. T now has three shares of voting common with a basis of $20 each.

VIII. MUTUAL FUNDS.

A. Taxes.

1. Conduit for tax purposes.

2. Distributions (Form 1099-DIV).

a. Dividends.

(1) Total Ordinary Dividends—taxed at ordinary income rate

(2) Qualified Dividends—taxed at new reduced 15% or 0% rate depending on tax bracket

(a) Dividends received from a domestic corporation or a qualified foreign corporation (one that is incorporated in a US possession or is incorporated in a country that has a current tax treaty with the US and meets various other qualifications)

(b) Holding period: must have held the stock on which the dividends are paid for more than 60 days during the 120 day period that begins 60 days before the ex-dividend date. The ex-dividend date is the last date on which a shareholder of record is entitled to receive the upcoming dividend.

(c) The following "dividends" are **NOT** qualifying dividends: dividends from a Section 501 corporation; insurance company dividends.

b. Capital gains.

(1) Total capital gain distributions

(2) Post-5 May 2003 capital gain distributions

c. Reporting Distributions.

TYPE OF DISTRIBUTION	WHERE TO REPORT IF TOTAL DIVIDENDS FROM ALL PAYERS ARE:	
	$1,500 or less	**More than $1,500**
Ordinary dividends Form 1099-DIV, Box 1a	Form 1040, line 9a.	Schedule B, Line 5.
Capital gain distributions Form 1099-DIV, Box 2a (filing Schedule D)	Schedule D, Line 13.	Schedule D, Line 13.
Return of Capital (nontaxable) distributions (Form 1099-DIV, box 3)	Generally not reported.	Generally not reported.
Exempt-interest dividends (Not on Form 1099-DIV)	Form 1040, line 8b.	Form 1040, line 8b.

3. Important dates.

a. Record date: date on which mutual fund determines which shareholders are entitled to distribution.

b. Trade date: date shares sold or exchanged.

4. Timing. Investing in a fund on or before a record date for a distribution results in liability for taxes on distribution.

Example: Taxpayer invests $1,000 in a fund with shares selling for $10 and shortly thereafter the fund makes a $2 per share capital gains distribution. The distribution is taxable.

B. Capital Gains and Losses.

1. Dispositions.

a. Share redemption.

b. Check writing.

c. Exchange of shares.

2. Form 1099-B, Proceeds From Broker and Barter Exchange Transactions.

a. Investment companies reports sales price to the IRS in box 2 of Form 1099-B.

b. Some brokers do not subtract commissions and fees; they report the gross sales proceeds as the sales price.

c. Other brokers do subtract commissions and fees, reporting the net sale proceeds as the sales price.

3. Emergency Economic Stabilization Act:

a. Beginning in 2011, brokers were required to track cost basis for stocks. In 2012, they must track basis also for mutual funds. And in 2013, basis for options and debt instruments must be tracked as well.

b. Block 3 of the 1099-B will show basis for the reported sale if the broker has it.

c. If Block 6 is checked, then the sale was not of a covered security and basis would have to come from the client. Brokers are not required to report basis for stock purchased prior to 2011.

d. Block 8 of the 1099-B will indicate whether the client held the property long term or short.

4. Record Keeping. Necessary to establish gain/loss for tax purposes.

C. Reinvested Distributions. Mutual fund pays in the form of additional mutual fund shares.

Example: Suppose Taxpayer invested $10,000 in a fund over time. During the same period, the fund paid dividend and capital gains distributions of $800, which were reinvested in additional fund shares. The mutual fund properly reported these distributions to the taxpayer on Form 1099-DIV and the taxpayer reported them as current income. Assume taxpayer later sells all fund shares for $11,000. Some taxpayers err by reporting a $1,000 capital gain. In fact, the taxpayer's investment (basis) is really $10,800, yielding only $200 of gain.

D. Basis in Mutual Funds.

1. Specific identification method. Cost basis is original purchase price of shares specified for sale. This method lets taxpayer choose the shares that provide the most desirable tax result.

2. Taxpayer can elect to use one of two averaging methods. Treas. Reg. § 1.1012-1(e).

a. Single-category method: all shares regardless of holding period grouped in one category and averaged.

b. Double-category method: all shares in respective holding category grouped and averaged in each group.

3. Shareholder who does not elect either method must use normal, first-in, first-out (FIFO) method for matching cost with shares sold.

E. Special Gain or Loss Situations.

1. Fees.

a. Load or "front-end" fees. Purchase fees some mutual funds impose. Reduce investment, but are still part of cost basis for tax purposes.

Example: If taxpayer invests $1,000 in a fund charging 5% load, then taxpayer buys $950 of shares, but cost basis is $1,000 for tax purposes.

b. Redemption fees. "Back-end fees" charged when taxpayer redeems shares in some funds. Usually expressed as percent of amount redeemed. Taxpayer will not have to adjust tax cost if mutual fund reports sales proceeds net of redemption fees on Form 1099-B (If mutual fund does not so report, taxpayer increases basis by amount of fee paid per share).

c. Custodial and account maintenance fees are commonly charged.

(1) Both are deductible as "investment expenses" on Schedule A.

(2) IRA custodial fee only deductible if paid by separate check, not if redeemed from IRA.

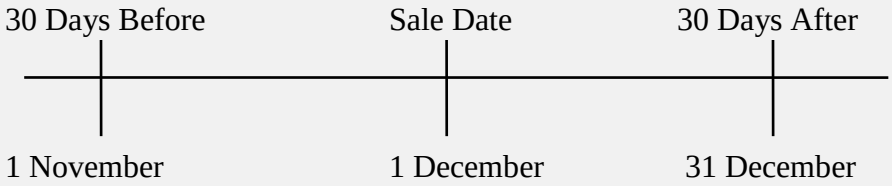
2. Capital losses and the "Wash Sale Rule."

a. Mutual fund wash sale rule: a capital loss is disallowed to the extent that the taxpayer purchased shares in the same fund within 30 days of (before and after) the sale. Rule designed to discourage short-term, loss-oriented selling.

(1) Avoid effect by not purchasing shares of a fund within 30 days before or after a loss realized.

(2) Illustration.

61-Day Wash Sale Period



November 1-30	30 days
December 1, day of sale	1 day
December 2-31	30 days
	61 days

b. Municipal bond fund losses. If taxpayer sells shares in a municipal bond fund as a loss and owned those shares for 6 months or less, the loss is disallowed to the extent that taxpayer received tax-exempt income from the same fund during that period.

c. Capital gains distributions and losses. If taxpayer holds shares in a mutual fund for 6 months or less, and during that period receives a capital gains distribution, then any capital loss realized from a sale of those shares is treated as a long-term capital loss to the extent of the capital gains distribution.

IX. REPORTING GAIN OR LOSS ON SCHEDULE D.

A. Schedule D is used to report gains or losses on the sale of stock or mutual funds.

B. 2011 and beyond: Must also complete Form 8949. Replaces the LTCG/STCG worksheet.

1. Complete a separate 8949 for each category of sales

a. Category A: Short term gains or losses where block 3 of the 1099-B shows basis.

b. Category B: Short term gains or losses where block 3 of the 1099-B does not show basis.

c. Category C: Short term gains or losses where no 1099-B is received.

d. Same categories for Long term gains and losses are on part II of the Form 8949 and listed as Categories D, E, and F.

C. Figure the gain or loss by subtracting the adjusted basis of stock from its sales price. If the sales price is greater, the taxpayer has gain of the sale. If the adjusted basis is greater than the sales price, the taxpayer has a loss on the sale.

D. The IRS will compare the amounts reported on all of a taxpayer's Forms 1099-B with the sum of the amounts reported on lines 3 and 10 of Schedule D. If the numbers do not agree and the taxpayer did not explain the difference, the IRS will contact the taxpayer.

X. CONCLUSION.

CHAPTER J

STANDARD AND ITEMIZED DEDUCTIONS AND TAX COMPUTATION

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APPENDICES

APPENDIX A – Fogg V. CIR, 89 T.C. 310 (1987) 62

CAUTION: This document is meant only as an educational outline for training purposes and as a starting point for conducting tax research. Many of the IRS publications and forms were not finalized at the time of the drafting of this document. In addition, numerous potential changes in tax law were being debated. Tax practioners are highly encouraged to check the IRS website www.irs.gov for the latest publications reflecting the most recent tax legislation which changes constantly.

STANDARD AND ITEMIZED DEDUCTIONS
AND
TAX COMPUTATION

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. Internal Revenue Code (I.R.C.).

B. Treasury Regulations (Treas. Reg.).

C. CCH, 2013 U.S. Master Tax Guide.

D. IRS Publications:

1. Pub. 17, Your Federal Income Taxes.

2. Pub. 526, Charitable Contributions.

3. Pub. 529, Miscellaneous Deductions.

4. Pub. 545, Interest Expense.

5. Pub. 550, Investment Income and Expenses.

6. Pub. 463, Travel, Entertainment, and Gift Expense.

7. Pub. 917, Business Use of a Car.

8. Pub. 508, Educational Expenses.

9. Pub. 521, Moving Expenses.

E. IRS Forms and Instructions.

II. INTRODUCTION.

AGI
Less-Deductions (either Standard or Itemized)
Less-Exemptions
Taxable Income (TI)

Find TI in tax table (filing status column) to determine tax rate.

III. STANDARD DEDUCTION. (I.R.C. § 63(c)).

A. 2016 Amounts.

Filing Status	2016 Standard Deduction Amount
Single	6,300
Married filing jointly/qualifying widow(er)	12,600
Head of household	9,300
Married filing separately	6,300

B. Additional Standard Deduction Amounts. (I.R.C. § 63(f)). Taxpayers who are age 65 (1 JAN 15 or earlier) or over or who are blind (of any age) (1 JAN 15 or earlier) qualify for larger standard deduction. The increase may be $1,250 per person if married, and $1,550 if single or head of household. This additional standard deduction amount is per disability. For example, "a married taxpayer filing jointly, both of who are over 65 and blind, would claim four of the additional standard deduction amounts." Rev. Proc. 2011-52 and CCH, 2013 U.S. Master Tax Guide, para. 126.

C. Standard Deduction For Dependent. (I.R.C. § 63(c)(5)). A dependent claimed on the taxpayer's return is entitled to a standard deduction on the dependent's return of the greater of $1,050, or the dependent's earned income plus $350, (up to $6,300 for singles). This amount is increased if the dependent is 65 or older or blind.

1. A "dependent" is defined in I.R.C. § 152. Just about any relative of the taxpayer qualifies as a "dependent" if the taxpayer provides over half the support (children, parents, grandparents, etc.).

   - A spouse is NOT a dependent for federal income tax purposes.

2. Earned income includes wages, salary, tips, professional fees, other compensation, and any amount received as a scholarship that must be included in income.

3. Note: The following are not eligible for the basic standard deduction (I.R.C. § 63(c)(6)):

   a. Married filing separate where either spouse itemizes.

   b. Nonresident alien.

   c. Taxpayer who changes accounting period and is required to file a return for less than 12 months.

   d. Estate, trust, or partnership.

IV. ITEMIZED DEDUCTIONS.

A. Taxpayer's Choice. If itemized deductions are less than the standard deduction, taxpayer should take the standard deduction. A taxpayer may change his mind even after filing the Form 1040 return by filing an amended return on Form 1040X.

1. Deductions must be authorized; i.e., the taxpayer must have some authority to justify any deduction (I.R.C. § 63(a)).

2. The authority must be in the Code, regulations, case law, or Revenue Rulings.

3. Reduction of Itemized Deductions. (I.R.C. § 68(b)) For taxable years beginning in 2016, allowable itemized deductions will be reduced if a taxpayer's AGI exceeds certain threshold levels. Those levels are as follows:

a. Married filing jointly or qualifying widow(er) – $311,300.

b. Single – $259,400.

c. Head of household – $285,350.

d. Married filing separately – $155,650.

B. Limitation: No Deduction for Expenses Paid with Tax Exempt Income. Expenses And Interest Relating To Tax-Exempt Income. (I.R.C. § 265)

1. Taxpayers cannot reduce nonexempt income by expenses and other items incurred in the production of exempt income other than interest. (I.R.C. § 265(a)(1)). This rule prevents them from obtaining a double exemption.

2. Although the title of (I.R.C. §. 265) uses the term "expenses," the text of the section does not. It uses the term "any amount otherwise allowable as a deduction." Deductions for taxes, as well as for expenses, have been disallowed under this provision.

3. Foreign income of nonresident alien. A statement in the law, such as in (I.R.C. §. 872(a)), to the effect that gross income of a nonresident alien individual "includes only the gross income from sources within the United States" is equivalent to an exemption, for nonresident alien individuals, of income from sources without the U.S. for the purposes of I.R.C. § 265. Accordingly, foreign taxes paid by nonresident aliens on income from sources without the U.S. are disallowed.

4. **Military and parsonage housing allowance exception.** Under (I.R.C. § 265(a)(6)), receipt of a parsonage housing allowance (I.R.C. § 107) or a military housing allowance is not to result in a denial of deductions for mortgage interest or real property tax on the taxpayer's home. Military personnel means member of the Army, Navy, Air Force, Marine Corps, Coast Guard, National Oceanic and Atmospheric Administration, and Public Health Service.

C. Medical and Dental Expenses. (I.R.C. § 213, Form 1040, Schedule A, lines 1-4) Deductible only to the extent they exceed 10% of AGI (I.R.C. § 213(a)). Deductible expenses include any amount paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, transportation costs on a trip taken primarily for and essential to medical care, and for medical insurance. (Rev.Proc. 2013-15)

1. Temporary exemption from increase for taxpayers age 65 or older.

   a. There is a temporary exemption from Jan. 1, 2013 to Dec. 31, 2016 for individuals age 65 and older and their spouses. If you or your spouses are 65 years or older or turned 65 during the tax year you are allowed to deduct unreimbursed medical care expenses that exceed 7.5% of your adjusted gross income. The threshold remains at 7.5% of AGI for those taxpayers until Dec. 31, 2016.

   b. Beginning Jan. 1, 2017, all taxpayers may deduct only the amount of the total un reimbursed allowable medical care expenses for the year that exceeds 10% of your adjusted gross income. Subject to pending approval of the Seniors Tax Hike Prevention Act of 2016 which delays the expiration of this temporary exemption for an additional two (2) years.

2. A taxpayer can deduct the premiums paid for insurance, which will be used to reimburse for medical, dental, and qualified long-term care costs (I.R.C. § 213(d)(l)(D)).

   a. Cannot deduct Medicare tax on wages or tips.

   b. Cannot deduct basic cost of Medicare insurance unless over age 65 and not entitled to social security. Medicare B premiums are deductible.

   c. Cannot deduct the cost of income replacement insurance.

   d. Cannot deduct insurance premiums paid with pretax dollars. Do not deduct any premiums paid by employers unless the premium is included in box of the Form W-2.

   e. Must reduce insurance premiums by any self-employed health insurance deduction taken as an adjustment to income on Form 1040, Line 29.

f. Limits on qualified long-term care deductions

(1) May deduct all unreimbursed expenses for qualified long-term care services:

(2) Limit on deductible premiums (Rev. Proc. 2013-15 and CCH, 2013 U.S. Master Tax Guide, para. 1019):

(a)	Age 40 or under	$390
(b)	Age 41-50	$730

(c)	Age 51- 60	$1,460
(d)	Age 61- 70	$3,900
(e)	Age 71 or over	$4,870

2. Medicine and drugs must be prescribed by a doctor or be insulin (I.R.C. § 213(b)).

3. The expenses must actually be paid during the year.

4. The expenses must not be compensated by insurance or otherwise (I.R.C. § 213(a)).

5. Transportation for medical care at 19 cents per mile for 2016, or actual out-of-pocket expenses, plus parking fees and tolls. (IRS Notice 2012-72)

6. Eligibility:

   a. The taxpayer is eligible to take the deduction for his medical expenses.

   b. The taxpayer may deduct his spouse's medical expenses if the individual is the spouse of the taxpayer either at the time medical services are rendered or when paid.

   c. The taxpayer may deduct his dependent's medical expenses if the individual is a dependent of the taxpayer either at the time medical services are rendered or when paid. "Dependent" is defined by the dependency exemption rules under I.R.C. §152.

   d. Special rule for child of divorced parents-such a child is treated as a dependent of both parents if the child meets the requirements of I.R.C. §152(e) (I.R.C. § 213(d)(5)). This means the parent who pays the qualifying medical expenses may claim them (even if not claiming the dependency exemption for the child).

e. See Instructions to Schedule A and Publication 502 for detailed examples of deductible medical expenses.

D. Taxes. (I.R.C. § 164 and 2013 CCH Master Tax Guide, para. 1021).

1. Taxpayers can deduct state, local, and foreign income taxes and real estate taxes. They can also deduct other taxes imposed by such jurisdictions for carrying on a trade or business or for producing income (I.R.C. § 164(a)).

2. State, local, and foreign income taxes. Taxpayer who itemizes deducts amount of state and local income taxes withheld for the tax year (shown on taxpayer's Form W-2) (I.R.C. § 164(a)(3)).

3. Real property taxes (I.R.C. § 164(a)).

a. Those taxes imposed by any state, local, or foreign taxing authority on real property for the general public welfare. Taxes must be based on the property's assessed value.

b. Taxes paid by a tenant are treated as additional rent and are not deductible by the tenant; the landlord may, however, deduct the taxes.

c. When real estate is sold, the seller and buyer each deduct a pro-rata share of the real property tax based on the number of days each owns the property.

d. Military and parsonage housing allowance exception. Under I.R.C. § 265(a)(6), receipt of a parsonage housing allowance or a military housing allowance is not to result in a denial of deductions for mortgage interest or real property tax on the taxpayer's home.

4. Personal Property Taxes. (I.R.C. § 164(a)(2)).

5. Foreign income taxes are deductible if paid to produce income. Taxpayer may deduct or take credit (Form 1116) unless paid on income exempt from U.S. tax under the foreign earned income exclusion. (I.R.C. § 164(a)(1)).

6. The following are **not** deductible on Schedule A:

a. Motor vehicle registration and inspection fees.

b. Inheritance taxes.

c. Gift taxes.

d. Per capita or poll taxes.

e. Tobacco or liquor taxes.

f. Taxes on gasoline or motor fuels.

g. Fees or charges such as: Driver's licenses, tolls, hunting licenses, fines, utility bills, transfer taxes on sale of home (however, if paid by seller they can reduce amount realized, if paid by buyer they can be added to basis).

h. Federal Income Taxes (to include social security, Medicare, and unemployment taxes).

E. Interest Expense. (I.R.C. § 163(h)).

1. Personal interest. No deduction for personal interest. (I.R.C. § 163(h). "Personal interest" means any personal interest allowable under this chapter [of the Internal Revenue Code] other than interest incurred in connection with a trade or business (I.R.C. § 162(h)(2)(A)) investment interest (I.R.C. §§ 163(h)(2)(B) and 163(d)), qualified residence mortgage interest (I.R.C. §§ 163 (h)(2)(D) and 163(d)), or passive activity interest (I.R.C. §§ 163(h)(2)(C) and 469). Examples: Interest on a personal loan, installment plan interest, bank credit card plan interest, finance charges, revolving charge account interest.

2. General Rules.

a. Only the person liable for the indebtedness can take the deduction. (RIA, USTR ¶ 1634.015).

b. No interest deduction for the purchase or carrying of life insurance or annuities (I.R.C. § 264(a)(2)).

c. The interest must accrue during the tax year so prepaid interest generally is not deductible (I.R.C. § 163(a)). One exception is prepaid mortgage interest.

Example: If you pay mortgage interest on the first of each month, and if you made a payment in December for January 1st, the interest is deductible in the year paid.

d. The interest must not be used to produce tax-exempt income (I.R.C. § 265(a)(1)).

e. Military and parsonage housing allowance exception. Under I.R.C. § 265(a)(6), receipt of a parsonage housing allowance or a military housing allowance is not to result in a denial of deductions for mortgage interest or real property tax on the taxpayer's home.

3. Qualified mortgage interest (I.R.C. § 163(h)(3)). For tax years after 1987, qualified residence interest means interest paid on "acquisition indebtedness" or "home equity indebtedness" on a "qualified residence."

a. "Acquisition indebtedness" is a debt used to acquire, construct, or substantially improve a home provided the debt is secured by a qualified residence.

(1) "Qualified residence" includes the taxpayer's principal residence (same definition as I.R.C. § 1034) and one other home (I.R.C. §§ 280A(d)(1), 163(h)(4)).

(2) Acquisition indebtedness may not exceed $1,000,000 ($500,000 for a married person filing a separate return) (I.R.C. § 163(h)(3)(B)). Pre-October 13, 1987, indebtedness for qualified residence is not subject to the $1,000,000 acquisition debt limit.

(3) Refinancings are treated the same as original acquisition debt but only up to the principal amount of the acquisition debt outstanding immediately before the refinancing. Once the original acquisition debt reaches $0, the homeowner is limited to deductions for interest on $100,000 of home-equity debt. Interest attributable to debt over these limits is nondeductible personal interest.

(4) Once the original acquisition debt is paid off, further borrowing will not qualify as acquisition debt unless the money is used to improve the home.

b. "Home equity indebtedness" is any indebtedness secured by a qualified residence to the extent of the lesser of the fair market value of the house, or $100,000 ($50,000 for married individual filing separately) (I.R.C. § 163(h)(3)(C)). Allows homeowners to deduct interest on home equity loans (up to $100,000) even if loan is used for personal purposes.

Example 1: **Taxpayer buys a home for $175,000 secured by a $150,000 mortgage. The mortgage qualifies as home acquisition debt because the loan amount does not exceed the home's cost. Therefore, because the acquisition indebtedness is less than $1 million, the entire amount of the interest payments is deductible.**

Example 2: Taxpayer bought a home for $110,000 and took out a mortgage of $95,000 ("acquisition indebtedness"). Taxpayer takes out a home equity loan in the amount of $42,500. Taxpayer's home equity debt, on which interest payments will be deductible as qualified home equity indebtedness, is limited to $15,000 – the smaller of (1) the $100,000 maximum limit or (2) the excess of the home's fair market value ($110,000) over the home acquisition debt ($95,000).

Example 3: Taxpayer bought a home and took out a mortgage of $50,000 ("acquisition indebtedness"). He reduced the mortgage by $10,000 over the years and now wants to refinance the home when it is worth $150,000. He wants to borrow $150,000, pay off the old mortgage of $40,000, and use the rest of the loan for other purposes. The breakout of the transaction is as follows:

- **$40,000 treated as acquisition indebtedness and the interest attributable to it is deductible**
- **$100,000 treated as home equity debt and the interest attributable to it is deductible**
- **$10,000 neither acquisition nor equity debt - interest on this amount is nondeductible**

Thus, about 93.3% of the interest is deductible.

4. Points.

a. Points paid by the borrower to get a mortgage are deductible as "interest" so long as they are "solely for use of or forbearance of money" and not a charge of money for services. This is so even if paid out of mortgage proceeds. Points paid by the borrower include: Loan origination fees (includes VA/FHA loan origination fee) and loan processing fees. (Rev. Rul. 87-22, 1987-1 CB 146; Rev. Proc. 94-27).

b. Seller-paid points:

(1) Points paid by the seller, such as loan placement fees that the seller may be required to pay to the lender as a condition to arrangement of financing terms for the buyer, are not deductible by the seller as interest. These are selling expenses which can be used to reduce the amount realized on the sale.

(2) Buyer must deduct these as interest if certain tests met.

c. Generally, points are deducted ratably over the term of the loan. (I.R.C. § 461(g)(1)). However, points paid by a cash method taxpayer, in connection with the purchase or improvement of a principal residence are treated as paid in the tax year of actual payment. (I.R.C. § 461(g)(2)).

d. Points paid in refinancing a mortgage, regardless of how the repayments are arranged, are not deductible in full in year paid unless paid in connection with the purchase or improvement of a home.

5. Mortgage insurance premiums treated as home mortgage interest. (IRS Pub. 936, Home Mortgage Interest Deduction; Line 13 Schedule A IRS Form 1040).

a. Premiums that paid or accrued for "qualified mortgage insurance" in connection with home acquisition debt on a qualified home are deductible as home mortgage interest. The amount deductible is reduced by 10% for every $1,000 ($500 if the filing status is married filing separately) by which the adjusted gross income exceeds $100,000 ($50,000 if the filing status is married filing separately). Mortgage interest premiums paid or accrued on any mortgage insurance contract issued before January 1, 2010, are not deductible as home mortgage interest. Mortgage insurance premiums paid or accrued after December 31, 2010, or that are properly allocable to any period after December 31, 2010, are not deductible as home mortgage interest.

b. Qualified mortgage insurance. Qualified mortgage insurance is mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance.

c. Special rules for prepaid mortgage insurance. If paid premiums for qualified mortgage insurance are properly allocable to periods after the close of the taxable year, such premiums are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is satisfied before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration).

6. Investment interest (I.R.C. § 163(d); Schedule A; see IRS Pub. 550, Investment Income and Expenses).

a. Investment interest is interest paid to purchase or carry property held for investment (I.R.C. § 163(d)(3)).

b. The term "investment interest" does not include:

(1) Any "qualified residence" interest, or

(2) Passive activity interest (I.R.C. § 163(d)(3)(B)).

c. Investments are capital assets like stocks, bonds, securities and other capital investment assets other than a principal residence.

d. A deduction for investment interest is limited to the amount of net investment income. Net investment income--the excess of income over expenses. The netting is done on Form 4952. Disallowed interest deductions can be carried forward to next year to be applied against investment income for that year (I.R.C. § 163(d)(2)).

Summary of where to deduct interest.

Type of interest	Where to deduct on Form 1040	Where to find information
Deductible home mortgage interest and points reported on Form 1098	Schedule A	Pub 936
Deductible home mortgage interest not reported on Form 1098	Schedule A	Pub 936
Qualified Mortgage Insurance and Points not reported on Form 1098	Schedule A	Pub 936
Investment interest (other than interest incurred to produce rents or royalties)	Schedule A	Pub 550
Business (non-farm) interest	Schedule C	Pubs 334, 535
Interest to produce rent/royalties	Schedule E	Pubs 527, 535
Personal interest	No deduction	

F. Charitable Contributions. (I.R.C. § 170(a)).

1. General requirements for charitable deduction:

a. The gift must be to a qualified organization.

(1) The taxpayer may deduct actual contributions to domestic religious, charitable, educational, scientific, or literary organizations. The IRS maintains a non-exhaustive list of qualified organizations (see Pub. 78 for the list and Pub. 526 generally and I.R.C. § 170(c)(2))

(2) I.R.C. § 6113 prohibits noncharitable fund-raising groups from soliciting unless they warn taxpayers targeted that donations are nondeductible.

b. The contribution must be made in the tax year. (I.R.C. § 170(a)(1)).

(1) A gift is completed in the year when it is unconditionally delivered to the charitable donee or its agent. The taxpayer takes the deduction for that year.

(2) If a check is mailed that clears in due course, or a properly endorsed stock certificate is received in the ordinary course of the mails, the contribution is made on the date of the mailing. (Treas. Reg. § 1.170A-1(b)).

(3) A deduction cannot be taken when the taxpayer merely promises or pledges to contribute, even if a bond or note is delivered—the deduction is available when the actual payment is made. (Rev. Rul. 68-174, 1968-1 CB 81; Sheldon B. Guren (1976) 66 TC 118).

(4) The IRS has ruled that a contribution through a charge to a credit card is deductible when the charge is made, regardless of when the bank is repaid. (Rev. Rul. 78-38, 1978-1 CB 67, distinguishing Rev. Rul. 68-174, 1968-1 CB 81, and revoking Rev. Rul. 71-216, 1971-1 CB 96).

c. The contribution must be made within the overall percentage of AGI limitations (I.R.C. § 170(b)).

(1) 50% of AGI for most charities (all public charities and private operating foundations as well as other non-operating foundations).

(2) 30% of AGI for veterans organizations, fraternal societies and non-profit cemeteries; gifts of capital gain property to 50% limit organizations; and gifts for the use of any organization.

(3) 20% of AGI for long term capital gain appreciated property contributed to a charity (other than capital gain property to a 50% limit organization.

(4) The contribution must be a completed gift.

2. You can deduct:

a. Contributions of cash and property to, or for the use of, a qualified organization.

b. The excess over the fair market value of any benefit received for a contribution to a qualified organization

c. Out-of Pocket Expenses if:

Example: Uniforms (Scouting, Red Cross Volunteer, Etc) and Car Expense (mileage at a standard rate of 14 cents per mile)

(1) Unreimbursed,

(2) Directly Connected with the services,

(3) Incurred only because of the services that the taxpayer gave, and

(4) Not personal, living, or family expenses.

d. Limits on Charitable Deductions for Clothing and Household Items I.R.C. § 170(f).

(1) To take the deduction, the clothing or household item contributed must be in good use condition or better.

(2) The deduction may be denied for contribution of clothing or household items of minimal monetary value (i.e., sock and undergarments).

(3) Subparagraphs (1) and (2) do not apply to any contribution of a single item of clothing or household good for which more than a $500 deduction is claimed if the taxpayer includes a qualified appraisal of the item along with the return.

3. You cannot deduct as a charitable contribution:

a. A contribution to a specific individual,

b. A contribution to a nonqualified organization,

c. The part of a contribution from which you receive or expect to receive a benefit,

d. The value of your time or services,

e. Your personal expenses,

f. Appraisal fees, or

g. Certain contributions of partial interests in property.

4. Record keeping. Taxpayers must keep records to prove the amount of cash and non-cash contributions they make during the year.

a. Taxpayers cannot deduct cash contributions regardless of amount unless records of the cash contributions are kept. (IRS Pub. 526; Treas. Reg. § 1.170A-13(a)). Contributions of may be substantiated by:

(1) A canceled check.

(2) A receipt from the charitable organization showing the name of the organization, the date of contribution, and the amount of the contribution;

(3) A letter or other communication from the donee charitable organization acknowledging receipt of a contribution and showing the date and amount of the contribution.

(4) Other reliable written records that show the name of the organization, the date of contribution, and the amount of the contribution. (Such as a bank record). A mere log is not sufficient.

b. Contributions of property of less than $250 to qualified organizations. The taxpayer must obtain a receipt that shows. (Treas. Reg. § 1.170A-13(b)(1)):

(1) The name of the charitable organization;

(2) The date and location of the contribution;

(3) A reasonably detailed description of the property.

(4) A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), and (3) will serve as a receipt.

(5) Taxpayers are not required to obtain a receipt when doing so would be impractical (for example, when the property is left at the charity‘s unattended drop site). However, they must keep reliable written records that show (Treas. Reg. § 1.170A-13(b)(2)):

(a) The name and address of the charitable organization;

(b) The date and location of the contribution;

(c) A detailed description of the property;

(d) The fair market value of the property;

(e) The cost or other basis of the property if the taxpayer must reduce the property‘s fair market value by appreciation;

(f) The amount the taxpayer can claim as a deduction if the taxpayer contributes less than her entire interest in the property.

(g) The terms of any conditions attached to a gift of property.

c. Contributions of property $250 or more but less than $500. The taxpayer must obtain a written acknowledgement from the charitable organization that shows:

(1) The name of the charitable organization;

(2) The date and location of the contribution;

(3) A reasonably detailed description of the property; and

(4) Whether the organization gave the taxpayer any goods or services in exchange for the contribution), and, if yes, a description of the goods or services and a good faith estimate of the value of the goods or services provided.

(5) The acknowledgement must be received on or before the earlier of:

(a) The date the taxpayer files her return for the year of the contribution; or

(b) The due date, including extensions, for filing the return.

(6) Taxpayers must also keep reliable written records that show:

(a) The name and address of the charitable organization;

(b) The date and location of the contribution;

(c) A detailed description of the property;

(d) The fair market value of the property;

(e) The cost or other basis of the property if the taxpayer must reduce the property‘s fair market value by appreciation;

(f) The amount the taxpayer can claim as a deduction if the taxpayer contributes less than her entire interest in the property.

(g) The terms of any conditions attached to a gift of property.

d. Contributions of property of more than $500 but less than $5,000. (Treas. Reg. § 1.170A-13(b)(3)). The taxpayer must have the acknowledgement and written records described in contributions of more than $250.00 but less than $500.00. The records must also include completion of Form 8283 showing the following or the deduction is not allowed:

(1) How the taxpayer acquired the property;

(2) The approximate date the taxpayer acquired or created the property; and

(3) The cost or basis of the property (not required for publicly traded securities).

e. Contributions of property of more than $5,000. The taxpayer must have the acknowledgement and written records described in contributions of more than $500 but less than $5,000. The taxpayer generally must also obtain an appraisal from a qualified appraiser. (Treas. Reg. § 1.170A-13(c)).

5. Reporting.

a. Gifts of cash. Taxpayers report cash gifts on schedule A.

b. Gifts of Property. Taxpayers report gifts of property on schedule A. The taxpayer must file Form 8283 if the value of <u>all</u> property given during the year is over $500.

(1) Generally, the amount of the deduction for contributed property is the FMV of the property at the time of the contribution.

(2) If the FMV of the property is less than basis the deduction is limited to the FMV.

c. Amounts that are disallowed as deductions this year carry forward for up to five years.

6. Car Donations. Section 884 of The American Jobs Creation Act of 2004, 118 Stat. 1418 (2004) altered the rules for contributions of used motor vehicles, boats, and planes after Dec. 31, 2004.

a. The rules adopted in the American Jobs Creation Act of 2004 (See IRS Notice 2005-44)

(1) Generally limit the deduction to the actual sales price of the vehicle when sold by the donee charity unless

(a) The charity makes a significant intervening use of the vehicle (such as using it to deliver meals on wheels),

(b) The charity makes a material improvement to the vehicle (Major repairs that significantly increase its value and not mere painting or cleaning),

(c) The charity donates or sells the vehicle to a needy individual at a significantly below-market price provided the transfer furthers the charitable purpose of helping a poor person in need of a means of transportation, or

(d) The fair market value of the vehicle is $500 or less.

(i) If the fair market value is $250 but less than $500, the donor must have an acknowledgment containing a description of the property, whether the donee provided any goods or services in consideration for the donation, and a good faith estimate of the value of the donated car.

(ii) If the donated vehicle is sold and the sale yields gross proceeds of $500 or less, the donor may be allowed a deduction equal to the lesser of the fair market value of the vehicle on the date of the contribution or $500.00.

(2) Requires donors to get a timely acknowledgment from the charity to claim the deduction.

(a) The acknowledgment must include:

(i) The name and taxpayer identification number of the donor;

(ii) The vehicle identification number;

(iii) Certain certifications, depending on the use or disposition of the vehicle by the donee organization.

(iv) If sold, date sold and gross sales proceeds

(b) The acknowledgment must be obtained within 30 days of the contribution or the disposition of the vehicle by the donee organization (although interim guidance provides for a longer period of time).

(c) The acknowledgment must be included with the donor‘s tax return on which the deduction is claimed.

(d) IRS Form 1098-C, required to be filed by the charitable organization may be used to satisfy the acknowledgement requirement.

(3) Fair market value

(a) Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and each having reasonable knowledge of relevant facts. (Reg. 1.170A-1(c)(2).

(b) Reasonable method of determining the fair market value of a qualified vehicle is by reference to an established used vehicle pricing guide provided the guide lists a sales price for a vehicle that is the same make, model, and year, sold in the same area, in the same condition, with the same or substantially similar options or accessories, and with the same or substantially similar warranties or guarantees. See, e.g. Rev. Rul 2002-67.

(c) For vehicles, an acceptable measure of the fair market value is an amount not in excess of the price listed in a used vehicle pricing guide for a private party sale of a similar vehicle. Do not use the dealer retail value.

7. The Charitable Mileage Rate for 2016 is 14 cents a mile.

Charitable Contributions Quick Check Chart Use the following lists for a quick check of charitable contributions.	
Deductible Charitable Contributions	**Nondeductible Charitable Contributions**
Money or property taxpayer gave to: • Churches, synagogues, temples, and other religious organizations. • Federal, state, and local governments, if contribution solely for public purposes. • Nonprofit schools and hospitals. • Public parks and recreation facilities. • Salvation Army, Red Cross, Care, Goodwill Industries, United Way, etc. • War veterans' groups Costs taxpayer paid for a student living with them sponsored by a qualified organization. Out-of-pocket expenses taxpayer incurred when serving as a qualified organization volunteer.	Money or property taxpayer gave to: • Civic leagues, social and sports clubs, labor unions, chambers of commerce. • Foreign organizations. • Groups that are run for personal profit. • Groups whose purpose is to lobby for law changes. • Homeowners' associations. • Individuals. • Political groups or candidates for public office. Cost of raffle, bingo, or lottery tickets. Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups. Tuition. Value of taxpayer's time or services. Value of taxpayer's blood given to blood bank.

G. Casualty/Theft Losses. (I.R.C. § 165(c)(3); Form 1040, Schedule A, line 19 & Form 4684).

1. Must be sudden and unexpected loss for nonbusiness property.

2. Types of casualty losses:

a. Fire.

b. Storm.

c. Shipwreck.

d. Other casualty.

e. Theft.

f. Also, bankruptcy or insolvency of financial institution. Taxpayer may report uninsured losses three ways:

(1) As a casualty loss on Schedule A (I.R.C. § 165(l)(1);

(2) As a miscellaneous itemized deduction on Schedule A (I.R.C. § 165(l)(5); or

(3) As a short-term capital loss on Schedule D (I.R.C. § 166(d)).

3. Nondeductible losses: (See generally, case annotations to statute.)

a. Progressive deterioration.

b. Termite or moth damage.

c. Diseases.

d. Drought.

4. Disaster losses – Presidential Declared Disaster Area. (I.R.C. § 165(i)).

a. Any loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act may, at the election of the taxpayer, be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred.

b. If an election is made under this subsection, the casualty resulting in the loss shall be treated for purposes of this title as having occurred in the taxable year for which the deduction is claimed.

5. Amount of loss equals the lesser of decrease in fair market value (FMV) or the adjusted basis. (Treas. Reg. § 1.165-7(b)).

a. Cannot consider sentimental value.

b. General decline in FMV because in or near an area that suffered casualty or might suffer another casualty is not deductible.

c. The cost of protecting property against casualty or theft is not deductible.

6. Limitations. (I.R.C. § 165(h)).

a. If covered by insurance, a claim must be filed (I.R.C. § 165(h)(4)(E)).

b. Also, the deduction must be reduced by the amount of the insurance or other compensation. (Treas. Reg. § 1.165-1(c)(4)).

c. The taxpayer must reduce each casualty/theft loss by $100 (I.R.C. § 165(h)(1)).

d. The taxpayer must reduce the total casualty/ theft losses during the tax year by 10% of AGI (I.R.C. § 165(h)(2)).

e. Special rules.

(1) If losses exceed gains (gains result from involuntary conversion) then only the excess losses over gains is subject to the 10% of AGI rule (I.R.C. § 165(h)(2)(A)).

(2) If gains exceed losses they are treated as capital gains (I.R.C. § 165(h)(2)(B)).

(3) Example 1: Taxpayer has $50,000 AGI (without regard to casualty losses), a $25,000 casualty gain, and a $15,000 casualty loss (after the $100 floor) will report a $10,000 capital gain on Schedule D. The 10% floor does not apply in this computation.

(4) Example 2: Taxpayer has $40,000 AGI, a $25,000 casualty loss (after the $100 floor), and a $15,000 casualty gain is allowed a $6,000 itemized deduction. The $10,000 loss resulting from netting the casualty gains against the casualty losses is deductible only to the extent that it exceeds 10% AGI ($10,000 - $4,000 = $6,000).

Deduction limit rules summarized

	$100 Rule	10% Rule
Definition of rule	Taxpayer must reduce each casualty or theft loss by $100 when figuring deduction. Taxpayer applies this rule after reducing loss by any reimbursement.	Taxpayer must reduce total casualty or theft loss by 10% of taxpayer's AGI (Form 1040, line 37). Taxpayer applies this rule after reducing loss by any reimbursement and by $100 (the $100 Rule).
Single event	Apply this rule only once, even if many pieces of property are affected.	
More than one event	Apply this rule to each event.	Apply this rule to the total of all events.
More than one person-with loss from same event (other than married taxpayers)	Apply the rule separately to each person.	
Married taxpayers--with loss from same event: Filing jointly Filing separately	 Apply this rule as if taxpayer were only one person. Apply this rule separately to each spouse.	
More than one owner (other than married taxpayers)	Apply the rule separately to each owner of jointly owned property.	

When to deduct a loss

Type of Loss	Tax Year Deducted	Choose Year?
Casualty losses	Year loss occurred	No
Loss on deposits: # casualty loss # bad debt # ordinary loss	 Year a reasonable estimate can be made. Year deposits are totally worthless. Year a reasonable estimate can be made.	 No No No
Federal disaster	Year disaster occurred or year immediately before disaster.	Yes
Thefts	Year of discovery of theft	No

H. Job Expenses and Most Other Miscellaneous Deductions. (I.R.C. § 67(a); Form 1040, Schedule A, lines 20-26, & Form 2106)

1. General. The following items can be deducted only to the extent they exceed 2% of the taxpayer's AGI:

a. Professional society dues.

b. Employment related educational expenses.

c. Office-in-home expenses.

d. Expenses of looking for a new job.

e. Professional books, magazines and journals.

f. Work clothes and uniforms not adaptable to general use.

g. Union dues and fees.

h. Certain unreimbursed employee business expenses.

i. Safe deposit box rental.

j. Tax counsel and assistance.

k. Cost of work-related small tools and supplies.

l. Investment counsel fees.

m. Fees paid to an IRA custodian.

n. Expenses allocated to shareholders or mutual funds and other publicly offered regulated investment companies.

2. Deductions Not Subject to the 2% Floor. Include the Following:

a. Casualty/theft losses (I.R.C. § 165(c)(3)).

b. Medical expenses (I.R.C. § 213(a)). (Subject to 7.5% floor).

c. Taxes (I.R.C. § 164).

d. Interest (I.R.C. § 163(h)).

e. Charitable contributions (I.R.C. § 170).

f. Gambling losses (but only deductible to the extent they off-set gambling winnings).

3. Employee Business Expenses.

a. Employee business expenses in general and travel away from home, local transportation, entertainment and educational expenses, in particular, perhaps cause more controversy than any other item on a military member's return. The controversy usually revolves around (i) whether a particular item is deductible, (ii) the amount of deduction available, or (iii) proof of the deduction.

b. Under I.R.C. § 62, only expenses paid or incurred by the taxpayer in connection with the performance by him of services as an employee, under a reimbursement or other expense arrangement with his employer, are deductible in computing adjusted gross income.

c. Expenses which do not qualify for deduction under I.R.C. § 62 may still be deductible under I.R.C. §§ 162 or 212 if the taxpayer itemizes deductions.

(1) I.R.C. § 67 makes these expenses miscellaneous itemized deductions that are subject to the 2% floor.

(2) Effective December 31, 1993, deductible meal and "entertainment" expenses must be reduced by fifty percent (50%) (I.R.C. § 274(n)(1)).

4. Reimbursed Expenses.

a. General Rule. An employee who adequately accounts to his employer is not required to report the reimbursement on his tax return if the advances or reimbursements equal the expenditures. Also, he need not report the advance or reimbursement as income, if he does not report the expense. No Form 2106 need be filed (Treas. Reg. § 1.162-17(b)(1)).

b. Where the reimbursements are in excess of the expenses, the excess constitutes income and must be reported as such. Form 2106 need not be filed; however, the income must be reported on Form 1040, 1040A or 1040EZ (Treas. Reg. § 1.162-17(b)(2)).

c. Where the expenses are in excess of the reimbursement, they may constitute a deduction. Form 2106 and Schedule A, Form 1040 must be filed to properly claim the deduction. However, if the excess employee business expenses do not exceed two percent of adjusted gross income, they are not deductible and Form 2106 need not be filed (Treas. Reg. § 1.162-17(B)(3)).

d. Per diem received by service members constitutes a tax-free allowance excludable from income. I.R.C. § 134, Letter from Assistant Secretary of Treasury to Undersecretary of Defense (Personnel and Readiness), dated 20 November 1996. However, see reimbursements above.

(a) However, the per diem or actual expense allowance, the monetary allowance in lieu of transportation, and the mileage allowance received by members of the Armed Forces, National Oceanic and Atmospheric Administration, and the Public Health Service, while in a travel status or on temporary duty away from their permanent stations, are included in their gross income except to the extent excluded under the accountable plan provisions of § 1.62-2. (Treas. Reg. § 1.61-2(b)(3)).

5. Substantiation. The employee must keep accurate records or sufficient evidence collaborating statements as to (1) amount, (2) time and place, (3) business purpose, and (4) business relationship of any entertained person. A detailed record must be kept, such as a diary, account book, or other statement of expense. The taxpayer must have documentary evidence for any lodging expense while traveling away from home and for any other expense of $75 or more (Treas. Reg. § 1.274-5T(c)(2)(iii) ($25 for expenditures before October 1, 1995 (Treas. Reg. § 1.274-5) Automobile use should be documented by recording the beginning and ending mileage readings.

Element to be proved	Expense			
	Travel	**Entertainment**	**Gift**	**Transportation** (car)
Amount	Amount of each separate expense for travel, lodging, and meals, including expenses may be totaled in reasonable categories, e.g., taxis, daily meals, etc.	Amount of each separate expense. Incidental expenses e.g., taxis, telephones, etc., may be totaled on a daily basis.	Cost of gift.	1) Amount of each separate expense including cost of the car. 2) Mileage for each business use of the car, and 3) Total miles for the year.
Time	Date taxpayer left and returned for each trip, number of days for business.	Date of entertainment or use of a facility for entertainment. For meals or entertainment directly before or after a bus. discussion, the date and duration of the bus. discussion	Date of gift.	Date of expense or use.
Place	Name of city or other destination.	Name and address or location of place of entertainment, or place of use of a facility for entertainment. Type of entertainment if not otherwise apparent. Place where bus. discussion was held if entertainment is directly before or after a bus. discussion.	Not applicable.	Name of city or other designation if applicable.
Description	Not applicable.	Not applicable.	Description.	Not applicable.
Business Purpose	Bus. reason for travel or the bus. benefit gained.	Bus. reason or bus. benefit gained. Nature of bus. discussion/activity.	Bus. reason for giving the gift or the bus. benefit.	Bus. reason for the expense or use of the car.
Business Relationship	Not applicable.	Occupations or other info--e.g., names or other designations--about persons entertained that shows their bus. relationship to taxpayer.	Occupation or other info--e.g., name or other designation--about recipient that shows bus .relationship to taxpayer.	Not applicable.

6. Threshold Requirement - must be **"Business Expense."**

   a. To be deductible, the expense must be an ordinary and necessary cost which bears a sufficient relationship to the taxpayer's business or income-producing activity and be reasonable in amount (I.R.C. §§ 162(a)(2) & 212).

b. If the expenditure is incurred primarily for personal purposes and bears little or no relationship to the taxpayer's business, it is not a deductible expense (I.R.C. § 262).

c. The expenses must also be "ordinary and necessary."

(1) "Ordinary" means common and accepted in the business.

(2) "Necessary" means helpful or appropriate; it does not mean absolutely indispensable.

(3) The expenses must also be "reasonable" in amount; i.e., not lavish or extravagant.

(4) Expenses related to tax-exempt income are not deductible.

d. The following are **not** ordinary business expenses and are not deductible:

(1) Dues paid by service-members to an officers' or a noncommissioned officers' club. (Rev. Rul. 55-250, 1955-1 C.B. 270).

(2) Uniforms for "special occasions" (like dress blues), absent a showing that military regulation prohibit wearing the uniform while off-duty. (Hatch v. Comm'r, 35 T.C.M. (CCH) 1737 (1976); Comm'r v. Motch, 180 F.2d 859 (6th Cir. 1950; Priv. Ltr. Rul. 81-20-036 (Feb. 18, 1981). Priv. Ltr. Rul. 80-34-132 (May 30, 1980)).

(3) Service member required to have hair cut every two weeks. (Drake v. Comm'r, 52 T.C. 842 (1969)).

(4) Expenses incurred by a Marine Corps artillery officer for a law school education, bar review course, and bar examination in order to qualify as a legal officer are not deductible as "educational expenses." (Rev. Rul. 72-450, 1972-2 C.B. 89).

(5) Out of pocket expenses for law books and other incidental expenses paid by Air Force FLEP student are nondeductible personal expenses under I.R.C. § 262. (Priv. Ltr. Rul. 80-43-128 (Aug. 1, 1980)).

(6) Stationery and callings cards. The service member failed to establish that the origin and character of these expenditures have a direct relationship to the service member‘s business. (Fogg v. Comm‘r, 89 T.C. 310 (1987)).

e. The following have been considered ordinary and necessary expenses in carrying on a trade or business (deductible).

(1) A Navy Captain whose assignments involve primarily command and administration of personnel may deduct educational expenses incurred in obtaining a master of arts degree in personnel administration. (Rev. Rul. 69-199, 1969-1 C.B. 51).

(2) Officer assigned several positions relating to national security matters. Educational program (degree of M.A. in International Securities Studies) expenses are deductible. (Priv. Ltr. Rul. 88-13-049 (Jan. 4, 1988)).

(3) Entertainment of employees incurred by an employer (commander, section chief, OIC) are deductible provided they entertainment is not lavish or extravagant. Examples would be buying subordinates a meal during duty hours when business is being discussed. (I.R.C. § 162).

(4) Leaders who provide social gatherings for all or selected organizational members and their families should be entitled to deduct those reasonable costs associated with the function as a business entertainment expense. (I.R.C. § 274(e); Treas. Reg. § 1.274-2(f)). However, a taxpayer is not allowed to deduct the expense of a party merely because he or she invited a few employees. These gatherings must pass the "directly related" to or "associated with" business test.

(5) Entertainment expenses incurred by a service member in connect with a change-of-command ceremony were deductible. (Fogg v. Comm‘r, 89 T.C. 310 (1987)).

(6) Contribution to Unit Fund. A contribution to the “Squadron Fund,” a fund maintained within a military unit by donations from the unit officers, that is used to purchase mementos, such as unit emblems, for departing personnel, to pay for flowers for personnel in hospital, etc., was held deductible. Note that this service member was expected to make a contribution as an officer/commander, and if he refused to contribute to the fund, his career might have been jeopardized. The service member did not receive any personal or substantial benefit from the fund. (Fogg v. Comm‘r, 89 T.C. 310 (1987)).

(7) Military fatigue uniforms (ACUs). (Fogg v. Comm‘r, 89 T.C. 310 (1987)).

(a) The amounts expended by service members on active duty for the purchase and maintenance of ACUs, where local regulations prohibit their off-duty wear, are, to the extent the expenses exceed allowances received, are deductible for income tax purposes as ordinary and necessary business expenses. (Rev. Rul. 67-115, 1967-1 C.B. 30).

(b) Cleaning of ACUs is deductible if meets the above test. (Drake v. Comm‘r, 52 T.C. 842 (1969)).

7. Expenses of Seeking Employment.

a. General Rule. To be deductible, the expenses must be in the same trade or business. However, it is not required that the job-hunting effort be successful.

b. Job-hunting expenses are not deductible if the taxpayer is seeking employment in a new trade or business, if he is a newcomer to the job market or if he has been unemployed for a substantial period of time. Thus, the deduction is not allowable if there is a substantial lack of continuity between the past employment and seeking new employment. (Rev. Rul. 75-120, 1975-1 C.B. 55).

c. Examples of deductible job-hunting expenses.

(1) Travel and transportation expenses are deductible on Form 2106 as a miscellaneous itemized deduction. Meal expenses are subject to a 50 percent reduction. If the trip is primarily personal in nature, no deduction can be taken. (Rev. Rul. 75-120, 1975-1 C.B. 55).

(2) Includes costs of typing, printing and mailing a resume, but the costs must be deducted as a miscellaneous itemized deduction on Schedule A.

(3) Expenses incurred by an Air Force Officer on active duty trying to find a new job after leaving the military were held not to be deductible because the job sought did not pertain to his former military duties. (Carter v. CIR, 51 T.C. 932).

(4) A retired Air Force Officer was denied a deduction for travel expenses incurred while seeking a new job. He was, in fact, seeking a new trade or business, as his service in the military could not be compared with any obtainable employment in the private sector. (Robert Eugene Evans, 42 T.C. Memo 602).

8. "Travel" Expenses.

a. General Rule and Includible Expenses. To be deductible, "travel" expenses must be ordinary and necessary and incurred in connection with the performance of duty (usually TDY) while away from home overnight (or for substantially longer than normal duty hours and, during the time away from home, the taxpayer needs to get rest or sleep in order to perform duties).

(1) Categories of deductible expenses (not all are listed on Form 2106) include the following:

Expense	Description
Transportation	Taxpayer's cost of travel by airplane, train, or bus between home and business destination.
Taxi, commuter bus, limo	Fares for these and other types of transportation between airport or station and hotel, or between hotel and work site away from home.
Baggage/ shipping	Cost of sending baggage and sample or display material between regular and temporary work sites.
Car	Costs of operating and maintaining car when traveling away from home on business. Taxpayer may deduct actual expenses or standard mileage rate, including business-related tolls and parking (business-related expenses for leased cars only).
Lodging	Cost of lodging if business trip is overnight or long enough to require taxpayer to get substantial sleep or rest to properly perform duties.
Meals	Cost of meals only if business trip is overnight or long enough to require taxpayer to get substantial sleep or rest to properly perform duties. Includes amounts spent for food, beverages, taxes, and related tips.
Cleaning	Cleaning and laundry expenses while away from home overnight.
Telephone	Cost of business (not personal) calls while on business trip, including business communication by fax or other device.
Tips	Tips paid for any expenses in the chart.
Other	Other similar ordinary and necessary expenses related to taxpayer's business travel (e.g., public stenographer's fees, computer rental fees). Rev. Rul. 63-145, 1963-2 C.B. 86.

b. Meals and Lodging. Deductible only if the travel is long enough to require sleep or rest. If the taxpayer returns home each evening, he may not deduct those expenses (Treas. Reg. § 1.162-1(g)).

(1) A one-day trip does not suffice, where a taxpayer is not away from home for a period of time that required a stop for sleep or rest. (Rev. Rul. 68-663, 1968-2 C.B. 71).

(2) Meals consumed at work, late at work, or while performing on-call duties, also do not qualify because they are not consumed while "away from home."

(3) Standard Meal Allowance. Instead of deducting the actual cost of meals while in travel status (and keeping a record of such expenses), a taxpayer can elect to deduct a "standard meal allowance." The IRS also has procedures for deducting a flat per diem amount for food and lodging expenses. See IRS Pub. 463 and Rev. Proc. 90-60; but see TAM 9433002, where IRS held officer could not use the standard meal allowance to determine deduction for employee business expenses where employer provided all meals.

c. Investors' Travel Expenses. (I.R.C. § 212).

(1) Travel expenses can be deducted as "nonbusiness" (i.e., itemized) expenses if paid or incurred (i) for the production or collection of income, (ii) for the management, conservation or maintenance of property need for the production of income, or (iii) in connection with the determination, collection or refund of any tax. Thus, investors can deduct the cost of meals and travel incurred in traveling away from home to look after income-producing property.

(2) The case law indicates there is no limitation on the distance an investor may travel or the time he may spend in looking after investment property.

(3) I.R.C. § 274(h)(7) disallows any deduction under § 212 for expenses allocable to a convention, seminar, or similar meeting. To be deductible, these expenses must qualify as ordinary and necessary expenses incurred in carrying on a trade or business. (I.R.C. § 162).

d. Part Business and Part Pleasure Trips. As long as business is still the main purpose of the trip, no allocation of travel expenses to nondeductible expenses is required for domestic travel. The IRS will focus on the amount of time spent on business as compared to personal activities in making the determination.

(1) In the case of foreign travel, however, a different rule applies. In this case, the taxpayer must generally allocate the percentage of expenses that were not related to business (I.R.C. § 274(c)(1)).

(2) No allocation is required if: (i) the travel does not exceed one week; (ii) the non-business activity is less than 25 percent of the total time on the travel; or (iii) if taxpayer has no substantial control (other than timing) over arranging the trip (Treas. Reg. §§ 1.274-4(f)(5)(i) and 1.274-4(g)).

(3) In the case of expenses incurred in attending a business convention in a foreign country, the taxpayer must show: (i) the meeting was directly related to the active conduct of the taxpayer's trade or business; and (ii) it is as reasonable for the meeting to be held outside North America as within it (I.R.C. § 274(h)(1)).

e. Travel expense deduction for a companion, Spouse or Dependent.

(1) No deduction is allowed (other than under I.R.C. § 217, moving expenses) for travel expenses paid or incurred for a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) unless (I.R.C. § 274(m)(3)):

(a) the spouse, etc., is an employee of the taxpayer, (I.R.C. § 274(m)(3)(A));

(b) the travel of the spouse, etc., is for a bona fide business purpose, (I.R.C. § 274(m)(3)(B)): and

(c) the expenses would otherwise be deductible by the spouse, etc. (I.R.C. § 274(m)(3)(C)):

(2) The limits on deductions for travel companions don't apply to a companion who

(a) is a business associate,

(b) comes along for a bona-fide business purpose, and

(c) could otherwise deduct the expense if he incurred it. (Treas. Reg § 1.274-2(g)).

(3) If a wife accompanies her husband on a business trip and her expenses aren't deductible, the deductible expense for transportation and lodging is the single rate cost of similar accommodations for the husband. But the full rental for a car in which both spouses travel is deductible, since no part of the expense is attributable to the "extra" spouse. (Rev. Rul. 56-168, 1956-1 CB 93).

f. Rules Applicable to Military Members. "Travel" expenses incurred by military personnel while on travel status on temporary assignments away from their permanent stations are deductible business expenses under I.R.C. § 162(a)(2).

(1) The deduction need not be offset by the basic subsistence and quarters allowance (which is non-taxable under Treas. Reg. §1.61-2(b)), unless the member is a reservist performing temporary active duty. (Rev. Rul. 55-572, 1955-2 C.B. 45).

(2) Expenses incurred in connection with a change of permanent duty station do not qualify as "travel" expenses, but may be deductible as a moving expense. (Rev. Rul. 76-2, 1976-1 C.B. 82).

(3) A military member's “tax home” is his duty station, not where his family lives, even if the family could not go with him. (Rev. Rules. 55-571, 1955-2 C.B. 44. and 67-438, 1967-2 C.B. 82).

(4) A member of the military services is “not away from home” while at his permanent duty station and may not deduct traveling expenses, including meals and lodging, incurred at such location. This is so even though it is not feasible or even permissible for his family to join him. (CIR v. H.A. Stidger, 386 U.S. 287 (1967)).

(5) Members of the U.S. Armed Forces on permanent duty assignments at official stations overseas are not traveling “away from home” and may not deduct their expenses for meals and lodgings at such locations, even though they are required to maintain homes in the U.S. for their families who are not allowed to accompany them. (Rev. Rul. 55-571, 1955-2 C.B. 44).

(6) A Naval Officer on permanent duty aboard ship has a tax home aboard the ship. The IRS has stated it will apply this rule to crewmen of nuclear submarines who serve six months of the year aboard the vessel and the other six months ashore. (Rev. Rul. 67-438, 1967-2 C.B. 82).

(7) An Army Officer could not deduct the cost of his meals in an officers' mess, a voluntary organization to which he belonged, or the expense of a “striker fee” (janitor service for his living quarters), inasmuch as he was not “away from home”. His place of business was his army post. (Bercaw v. CIR, 165 F.2d 521 (4th Cir. 1948)).

See also I.R.C. § 274(a)(3) which provides: “no deduction shall be allowed for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.”

(8) A ready reservist on temporary active duty, who has a place of business or employment which he retained and to which he will return after his period of service, is in travel status and may deduct his meals and lodging at his official military post of duty to the extent such expenses exceed any nontaxable basic subsistence allowances received for those expenses. The deduction does not include expenses for family members. (Rev. Rul. 63-64, 1963-1 C.B. 30).

(9) A serviceman's expenses in visiting home and in returning home after his discharge, including the cost of moving his family, are nondeductible personal expenses. (Frederick Tilney, Jr., 12 T.C.M. (CCH) 92, 1953).

g. National Guard/Reserve Travel Expenses in excess of the Federal per diem rate. Military Family Tax Relief Act of 2003 amended the Internal Revenue Code to allow an above the line deduction for expenses incurred by members of the National Guard or Reserve in conjunction with their military service for expenses incurred after December 31, 2002. See Adjustments Outline.

h. Travel Away From Home For Schooling. Expenses of travel, meals and lodging while away from home are treated the same as other travel expenses. The education itself must qualify as business related and must itself be deductible (it would be an itemized deduction). Expenses for local transportation from work to school would be deductible, but generally not from home to school. (These would be equivalent to non-deductible commuting costs-exception for schooling of limited duration). (G.F. Johnson, 39 T.C.M. 630 (1979)). See ―Education Expenses,‖ below.

9. “Transportation” and Commuting Expenses.

a. General Rule: “Transportation” expenses are a narrower concept than “travel” expenses. Deductible transportation costs include only the costs of transporting the taxpayer from one place to another in pursuit of his trade or business, other than commuting expenses incurred by the taxpayer while he is not in “travel status” (i.e., “away from home” overnight or for a period requiring sleep or rest).

(1) Transportation expenses include the cost of traveling by plane, train, bus, taxi, etc., and the business-related portion of the cost of operating and maintaining an automobile or other transportation conveyance (POV) (Treas. Reg. § 1.62-1(g)).

(2) A deduction from gross income for transportation expenses is available to employees (as well as self-employed persons) so long as the expenses are directly attributable to the employee's employment (I.R.C. § 62(2)(c)).

(3) Commuting costs are expenses incurred by individuals in traveling between their residences and their established places of business or employment and are non-deductible personal expenses rather than deductible business (or nonbusiness) expenses (Treas. Reg. §§ 1.162-1(g), 1.162-2(e), 1.212-1(f), and 1.262-1(b)(5)).

(4) Commuting from a personal residence to work is not deductible. This is true regardless of the length of the trip. This is also true regardless of transportation used and regardless of the availability or nonavailability of public transportation. Tolls are considered part of the cost of commuting, as are car pool payments. Rev. Rul. 55-555, 1955-2 C.B. 20.

b. Automobile Expenses.

(1) An employee who uses his POV for business purposes can generally deduct the costs allocable to business use (i.e., for both “travel” and “transportation” expenses) in either of the following two ways: (i) the actual cost of operating his car for business purposes or (ii) the optional standard mileage rate. However, unless the employee can show that his use of the car is (i) for the employer's convenience and (ii) required as a condition of employment, the employee cannot claim deductions for depreciation. I.R.C. § 280F(d)(3).

(2) Even if the employee satisfies the tests above, if business use of automobile is less than 50 percent of total use of the automobile, I.R.C. section 280F(b) reduces or eliminates MACRS deductions, investment tax credits and the Section 179 expense election. Thus, in virtually every case, military members will use the “standard mileage rate,” discussed below.

(3) Automobile expenses are a deductible I.R.C. § 212 expense when incurred in connection with the production or collection of income or the management, conservation or maintenance of property held for that purpose. Treas. Reg. § 1.212-1.

(4) The Business Mileage Rate for 2016 is 54 cents per mile. It does not include parking fees and tolls (reported separately on Form 2106) incurred in connection with business use, interest and state and local taxes relating to the car, such as interest and sales taxes paid on the purchase of a car (which are reported as itemized deductions on Schedule A). (Rev. Proc. 2009-54).

(5) POV Used for Both Business and Pleasure - Allocation of Expenses. In Part II of Form 2106, taxpayers must allocate expenses between business and nonbusiness use, based on mileage. The resulting percentage is used for computing the deduction under the actual cost method. Parking fees and tolls are listed separately on Form 2106 and taxes and interest allocable to personal use can be deducted as an itemized deduction.

10. Entertainment Expenses.

a. Requirements for Deductibility. In order to be deductible, entertainment expenses generally must meet the following requirements:

(1) All "ordinary and necessary" expenses paid or incurred in carrying on a trade or business are deductible. A military officer is engaged in a trade or business. (Carlisle v. Comm'r, 37 T.C. 424, 429 (1961); Lindsay C. Howard, 16 T.C. 157,161 (1951), aff'd 202 F.2d 28 (9th Cir. 1953)).

(2) Ordinary means common and accepted in the field of business. Necessary means helpful and appropriate for the business. In addition, the entertainment expenditures must meet one of two tests:

(a) Directly Related Test. The main purpose of the combined business and entertainment was the active conduct of business, business was conducted, and the taxpayer had more than a general expectation of getting income or some other specific business benefit at some time in the future.

(i) A business entertainment expense qualifies as "directly related"—and therefore deductible—if an active business discussion occurred during the entertainment activity or if the entertainment activity took place in a clear business setting. (See Treas. Reg. § 1.274-2(c)(3) and (4); Moore v. U.S., 943 F.Supp. 603 (E.D. Va. 1996)).

(ii) A taxpayer can show that entertainment occurred in a clear business setting by "clearly establishing that any recipient of the entertainment would have reasonably known that the taxpayer had no significant motive, in incurring the expenditure, other than directly furthering his trade or business." (Treas. Reg. § 1.274-2(c)(4);); Moore v. U.S., 943 F.Supp. 603 (E.D. Va. 1996)).

(iii) Generally speaking entertainment will not be considered to have occurred in a clear business setting if the entertainment is marked by substantial distractions, e.g., a meeting or discussion at a night club or during essentially social gatherings such as cocktail parties, or a meeting or discussion including persons other than the taxpayer's business associates at places such as cocktail lounges. (See Treas. Reg. § 1.274-2(c)(4) and (7); Moore v. U.S., 943 F.Supp. 603 (E.D. Va. 1996)).

(iv) Nonetheless, some entertainment which is accompanied by substantial distractions—such as the entertainment of business and civic leaders at the opening of a new hotel or theatrical production where the taxpayer's obvious intention is to obtain business publicity as opposed to maintaining goodwill—may be considered to have occurred in a clear business setting if there was no meaningful personal or social relationship between the taxpayer and the recipients of the entertainment. (See § Treas. Reg. 1.274-2(c)(4); Moore v. U.S., 943 F.Supp. 603 (E.D. Va. 1996)).

(b) Associated Test. The entertainment must be associated with the taxpayer's trade or business and directly precede or follow a substantial business discussion.

(3) Effective for expenses paid after 1993, only 50% of otherwise deductible entertainment expenses qualify for deduction. (I.R.C. § 274).

b. Application to the Military. Section 162(a) allows deductions for current business expenses while section 262 disallows deductions for "personal, living, or family expenses." The proper test to be applied in resolving the tension between section 162 and section 262 is "whether the expense was 'business' or 'personal.'" (Fogg v. Comm'r, 89 T.C. 310, 316 (1987)).

(1) The Personal Money Allowance received by Lieutenant Generals and Generals is gross income. However, Congress provided the allowance in recognition of the additional expenses peculiar to the military ranks or positions in question. See H.R. Rep. No. 640, 80th Cong., 1st Sess. 12 (1974). To the extent that the officer expends these funds for their intended purpose of defraying certain costs incurred in connection with their official duties, the expenses should be deductible as ordinary and necessary business expenses. Rev. Rul. 77-350, 1977-2 C.B. 21.

(2) Other officers must establish that "the origin and character of the events or circumstances that give rise to the expenditures in question are directly related to petitioner's trade or business of being a military officer." (Fogg v. Comm'r, 89 T.C. 310, 317 (1987)).

(3) In Fogg, a Marine LTC deducted the costs associated with a change in command ceremony reception and the cost of contributions to a squadron unit fund. LTC Fogg introduced evidence that showed all commanders were required to engage in "official entertaining," including change in command ceremonies and that his career might have been jeopardized if he failed to contribute to the squadron fund. The Tax Court found that the reception was required by LTC Fogg's employer (even though he was not under a direct order to do so) and that they directly flowed from a business ceremony. The Court drew an analogy between the officer and a "hard-headed businessman" and determined that the businessman would have incurred the expenses. Because LTC Fogg convinced the Court that he was expected to contribute to the squadron fund or his career would be jeopardized, the Court ruled that the expenses were deductible being appropriate, helpful, and necessary for his career.

(4) In Pollock v. Comm'r, 10 B.T.A. 1297 (1928), which is relied on in Fogg, the petitioner, a Naval Officer, was appointed as Governor of American Samoa. In connection with his duties, the petitioner was required to extend courtesies to representatives of other countries; amounts for which the petitioner was not reimbursed. Refraining from making the expenditures, however, would not have been consistent with the petitioner's duties. The court opined that the continuance of the petitioner's Naval standing, from which his income was derived, would have been seriously jeopardized had he failed to make the expenditures; therefore, the amounts paid out of his personal funds were deductible as ordinary and necessary expenses. Thus, while the officer in Pollock may not have been under a direct order, the Court recognized that one need not be threatened with a court martial in order for an expenditure of a military officer to be considered "necessary."

(5) Carlisle v. Comm‘r, 37 T.C. 424 (1961) held that expenses incurred in securing a medical discharge were not deductible because they were not ordinary and necessary to the business of being an Army officer. The Court had “difficulty in understanding how expenses incurred to expedite a discharge from the Army are ordinary and necessary in carrying on that business. Such expenses appear neither ordinary nor necessary to such a business under even the most broad reading of the statute.” Similarly, it is unlikely that expenses incurred in connection with a retirement ceremony would be deductible.

11. Professional Persons' Special Expenses.

a. General Rule.

(1) Professional persons who are also employees (e.g., attorneys, physicians, teachers) can deduct as an itemized deduction on Schedule A the cost of supplies used in the practice of their profession, dues paid to professional associations, subscriptions to professional journals and the cost of professional books with a short useful life.

(2) The case law has allowed the deduction of the cost of a briefcase by a salesman; this rule should also apply to attorneys, teachers and other professionals for whom a briefcase is a necessary part of their professional duties.

b. Attorneys.

(1) Special expenses of attorneys which have been held to be deductible include bar association dues, cost of home telephone used for business and depreciation of tape recorder used for business only.

(2) Fees paid to take bar examinations and for admission to practice before federal court and travel expenses to obtain license to practice before Supreme Court have been held to be capital expenses amortizable over the taxpayer's life expectancy.

12. Education Expenses.

a. General Rule.

(1) A deduction is allowable for educational expenses if the expenses meet either of the following two tests and are not otherwise disqualified (see b below): (i) the education maintains or improves skills required by the individual in his employment or other trade or business or (ii) the education meets the express requirements of the taxpayer's employer or the requirements of applicable law or regulations, imposed as a condition to the taxpayer's retention of this employment, status or rate of compensation. These costs are deductible even if the education may lead to a degree.

(2) Deductible expenses include the following items:

(a) Tuition;

(b) Books;

(c) Laboratory and other fees; and

(d) Similar items.

(3) Travel and transportation expenses, including meals and lodging, may also qualify for deduction.

(4) Reimbursement by Veterans Administration (VA) (or tax-free scholarship). Deductible education expenses incurred by veterans must be reduced by nontaxable payments received from the VA. Rev. Rul. 83-3, 1983-1 C.B. 72.

(a) The IRS considers 50 percent of VA benefits to be allocable to education expenses and 50 percent allocable to personal living expenses. Id.

Example: The taxpayer incurs $1,000 of education expenses during the year and receives nontaxable VA benefits of $780. Since the IRS considers $390 (50% 0f $780) attributable to educational expenses, the taxpayer may deduct $610 of the educational expenses ($1,000 - $390 = $610).

(b) If only a part of the educational expenses are deductible, the portion of the VA reimbursement allocable to education expenses, which reduces the education expense deduction, is determined as follows:

(i) Multiply total deductible expenses by a fraction, the numerator of which is the portion of the reimbursement allocable to education expense and the denominator is the total education expense.

(ii) Subtract the amount determined in (i) from the deductible education expenses. Id.

Example: The taxpayer incurs $1,500 of educational expenses and receives nontaxable VA reimbursements of $780--$390 attributable to deductible expenses. $740 of the expenses is deductible. ($1,000 x $390/$1,500 = $260; $1,000 - $260 = $740).

b. Nondeductible Education Expenses. The following categories of education expenses are not deductible:

(1) Education needed to meet the minimum requirements for the taxpayer's qualification in his employment or other trade or business.

(2) Education which is part of a program of study being pursued by the taxpayer which will lead to qualifying him for a new trade or business.

(3) No deduction is allowable if the taxpayer is not currently employed or otherwise engaged in a trade, business or profession.

(a) However, a person who leaves work to pursue full-time graduate study can deduct education expenses where he has temporarily suspended engaging in employment or other trade or business.

(b) The IRS has ruled that a suspension of one year or less will be considered temporary if the taxpayer resumes his former employment or trade or business. However, it is not required that the taxpayer (i) take a formal leave of absence, (ii) execute a reemployment agreement or (iii) actually return to employment with the same employer.

c. Education Required to Keep Salary, Status or Employment.

(1) The case law generally holds that learning new techniques required by technological change to keep present salary, status and employment are deductible.

(2) Expenses are deductible if the education is undertaken to meet <u>increased requirements</u> for the taxpayer's current position.

(3) Expenses incurred due to the employer's change of employee's duties are deductible, if the duties involve the same general type of work.

(4) Where education is required, only the expenses allocable to the education necessary to meet the <u>minimum</u> requirements are deductible.

(5) No deduction is allowable if the education required by the employer will lead to qualification for a new trade or business—even if the employee intends to remain an employee in his present position. <u>Example</u>. Bank requires trust officer to study law.

d. Education which maintains or improves business skills.

(1) To be deductible, the education courses must have a proximate relationship to skill level required by the job; education pursued to increase general understanding does not qualify. Refresher and current development- type courses do qualify.

(2) Cost of obtaining LLM. The case law generally holds that the taxpayer must have first practiced law in order to deduct expenses. The Tax Court has held that a three or four month period of practice would support the deduction of LLM-related expenses. Ruehmann, T.C. Memo 1971-157.

e. Examples of cases involving military taxpayers.

(1) Graduate courses leading to a masters degree in personnel administration taken by a Navy line officer whose duties included command and administration activities.

(2) Courses leading to a masters of business administration taken by an Air Force NCO whose duties constituted primarily record keeping activities.

(3) English literature courses taken by an Army JAG (defense attorney) to "improve brief-writing" abilities.

(4) Flight engineer courses taken by an Air Force pilot.

(5) College courses taken by enlisted soldier in order to earn promotion points.

f. Transportation and travel expenses incurred in connection with deductible education expenses.

(1) Local transportation expenses are deductible if taxpayer is employed.

(a) You can deduct the costs of going from work to school. You may also deduct the costs of going from school to home if you are regularly employed and are attending school on a temporary basis.

(b) If the taxpayer is regularly employed and returns home before going to school, he can deduct the cost of going from home to school provided he is only attending school temporarily.

(2) Travel, meals and lodging costs are also deductible if the travel away from home is undertaken primarily to obtain education, the costs of which are otherwise deductible under the rules discussed above.

g. How to report educational expenses.

(1) If no expenses have been incurred for meals or transportation and if none of the expenses were reimbursed by the employer, Form 2106 need not be used. Instead, the education expenses are reported as a miscellaneous itemized deduction on Schedule A to Form 1040.

(2) If some educational expenses are attributable to travel and transportation (or if some of the expenses were reimbursed by the employer), all expenses are reported on Form 2106 or 2106-EZ. Note that expenses for meals will be subject to an 50 percent reduction.

13. Other Miscellaneous Deductions. (Schedule A).

V. CALCULATING THE TAX.

A. **Introduction**: After you have figured your income and deductions, the next step is to calculate the tax.

B. **Calculating the Tax – Ordinary Income**

1. The income tax liability is based on the taxpayer's taxable income.

2. After figuring the income tax, subtract tax credits and add any other taxes owed. The result is the total tax liability. Compare the total tax with the total payments to determine whether the taxpayer is entitled to a refund or owes additional tax.

3. Use the Tax Table if the taxpayer's taxable income is less than $100,000.

Example. Mr. and Mrs. Brown are filing a joint return. Their taxable income on line 43 of Form 1040 is $25,350. First, they find the $25,300–25,350 income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the income line and filing status column meet is $2,929. This is the tax amount they should enter on line 44 of their Form 1040.

SAMPLE TABLE

At Least	But less than	Single	Married Filing Jointly	Married Filing Separately
		YOUR TAX IS ---		
25,200	25,250	3,349	2,914	3,349
25,250	25,300	3,356	2,921	3,356
25,300	25,350	3,364	2,929	3,364
25,350	25,400	3,371	2,936	3,371

NOTE: Tax Tables base tax calculations on an amount at the <u>midpoint</u> of a given income range. So the Brown's taxes are calculated as though their taxable income were $25,325.

The Brown's are in the 15% tax bracket.

Manual Computation Example:

Remember – The first $17,850 will be taxed at 10%.

$25,325 – 17,850 = $7,475

$7,475 x 15% = $1,121.25

Allow for the 10% Tax Bracket

$1,785 + 1,121.25 = $2,906.25

4. If $100,000 or more, use the Tax Rate Schedules.

Example: Assume the same facts as above, except that the Brown's taxable income on line 43 of Form 1040 is $105,300. First, find the proper schedule for their filing status. For the Browns, that is the schedule for filing status Married Filing Jointly or Qualifying Widow(er). Next the Browns look to the left column of the schedule where they are instructed to refer to by line 43 (taxable income) of the Form 1040. Since the Brown's taxable income is over $70,700, but not over $142,700, the Browns are in the 25% income tax bracket. The schedule instructs the Browns to enter on Form 1040, line 44 (tax) $9,735 plus 25% of the amount over $70,700. The Browns simply subtract $70,700 from their taxable income of $105,300 leaving $34,600. They then multiply this amount by 25%, resulting in $8,650. The Browns then add the $8,650 to $9,735 as instructed to determine their total tax of $18,385. This is the tax amount they should enter on line 44 of their Form 1040.

	If the amount on Form 1040 line 43, is OVER---	But not OVER--	Enter on Form 1040, line 44	+	of the amount over-----
Married Filing Jointly or Qualifying Widow(er)	$0	$17,850	$0.00	10%	$0.00
	$17,850	$72,500	$1,785	15%	$17,850
	$72,500	$146,400	$9,982.50	25%	$72,500
	$146,400	$223,050	$28,457.50	28%	$146,400
	$223,050	$398,350	$49,919.50	33%	$223,050
	$398,350	--	$107,768.50	35%	$398,350

TI	$ 105,300
Less	<72,500>
Total	32,800
Multiply by	.25
Result	8,200
Add	9,982.50
TAX	**18,182.50**

C. **Calculating the Tax – Capital Gain:**

1. If the taxpayer has a net capital gain on Schedule D (line 16 of Schedule D is a gain) or if you have qualified dividends on Form 1040, line 9b and the amount on Form 1040, line 43 is more than zero, use Part IV of Schedule D to calculate the tax.

2. Recall that capital gains are taxed at more favorable rates than ordinary income.

   a. Ordinary Income: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%

   b. Capital Gains: 20%, (a special 3.8% surtax in some cases), 25%, & 28%.

OBSERVATION: Taxpayers with taxable income will always pay a lower rate of tax on net capital gain as compared to their ordinary income.

Example. Sam is a taxpayer in the 15% tax bracket. His income includes $1,000 of net capital gain. Sam's tax on the capital gain portion of his income is $0. The tax on $1,000 of ordinary income is $150.

Example. Sue, a taxpayer in the 35% tax bracket, has net capital gain of $10,000. Sue's tax on the capital gain is $2,000, a saving of $1,500 over the tax on a comparable amount of ordinary income which would have been $3,500.

3. Schedule D, and it attendant worksheets, segregates the ordinary income from the capital gains; categorizes the various types of capital gain; and taxes each at its appropriate rate.

4. Failure to use Schedule D or the appropriate worksheets, and merely relying of the tax table and schedule, when capital gain is present, will result in a higher and incorrect tax calculation for the taxpayer.

VI. CONCLUSION.

John R. Fogg and Patricia L. Massey Fogg, Petitioners v.
Commissioner of Internal Revenue, Respondent

Docket No. 7780-86

UNITED STATES TAX COURT

89 T.C. 310; 1987 U.S. Tax Ct. LEXIS 117; 89 T.C. No. 27

August 20, 1987; As amended August 31, 1987
August 20, 1987, Filed

DISPOSITION: [**1]

Decision will be entered under Rule 155.

CORE TERMS: entertainment, custom, boat, ceremony, expenditure, club, change-of-command, deductible, military, reception, military officer, stationery, personal effects, sailboat, cards, personal effect, yacht, entitled to deduct, new residence, memorandum, carrying, employee business, expenses incurred, commanding, duties, direct relationship, business expense, burden of proof, non-business, intimate

SYLLABUS: Held, expenses incurred in moving a sailboat are moving expenses under sec. 217, I.R.C. 1954. Aksomitas v. Commissioner, 50 T.C. 679 (1968), distinguished. Held, further, entertainment expenses incurred by a military officer in connection with a change-of-command ceremony and amounts paid to a ‒Squadron Officers Fund‖ are deductible under sec. 162. Held, further, petitioner failed to establish that expenses for dues, stationery, and calling cards are deductible under sec. 162.

COUNSEL: James R. Harper, for the petitioner.

J. Mack Karesh, for the respondent.

JUDGES: Shields, Judge. Powell, Special Trial Judge.

OPINIONBY: SHIELDS; POWELL

OPINION: [*311] OPINION

This case was assigned to Special Trial Judge Carleton D. Powell pursuant to the provisions of section 7456(d) n1 (redesignated as section 7443A(b) by the Tax Reform Act of 1986, Pub. L. 99-514, sec. 1556, 100 Stat. 2755) and Rule 180 et seq. The Court agrees with and adopts the opinion of the Special Trial Judge, which is set forth below.

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n1 All statutory references are to the Internal Revenue Code of 1954, as amended, and as in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise provided.

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OPINION OF THE SPECIAL TRIAL JUDGE

Powell, Special Trial Judge: Respondent determined a deficiency in petitioners' Federal income taxes for the taxable years 1982 and 1983, of $1,000 and $181.90, respectively. The case was submitted on a stipulation of facts pursuant to Rule 122.

After concessions, the issues for decision are (1) whether petitioners are entitled to deduct the cost incurred in moving a sailboat pursuant to section 217; (2) whether, under section 162, petitioners are entitled to deduct entertainment expenses incurred in connection with a “change-of-command” ceremony, and (3) whether petitioners are entitled to deduct various miscellaneous expenses pursuant to section 162.

FACTS

The stipulation of facts and attached exhibits are incorporated herein by reference. Petitioner John R. Fogg (hereinafter Col. Fogg or petitioner) is a Lieutenant Colonel in the U.S. Marine Corps. He was a Marine officer on active duty throughout the years 1982-83. At the time they filed their petition, petitioners resided in Beaufort, South Carolina. The petitioners were married throughout 1982-83, and filed joint income tax returns for those years.

1. Moving Expenses

On their [**3] 1982 return, petitioners claimed a moving expense deduction of $2,530. The amount in dispute, $1,796, [*312] consists of their actual expenses incurred in moving a sailboat from their old residence in Florida to their new residence in South Carolina. The boat moving expenses were not reimbursed by the Marine Corps. The parties have agreed that petitioners made a job-related move.

The boat, a 36-foot sailboat, has not been used in a trade or business or for investment purposes. Instead, petitioners are active sailors and had frequently used the boat for recreational activities. In addition, they resided on the boat for 2 weeks prior to their departure from Florida, and for 9 weeks after their arrival in Beaufort. The boat was purchased in 1978 and kept by petitioners until 1984 when they replaced it with another boat. As stipulated by the parties, the issue before this Court is whether petitioners' sailboat is a “personal effect” within the meaning of section 217(b)(1)(A).

2. Entertainment and Miscellaneous Expenses

Petitioner Col. Fogg claimed employee business expenses for the taxable years 1982 and 1983, which respondent disallowed for the most part. After concessions, [**4] the employee business expenses remaining in dispute are as follows:

	1982
Functions	$ 1,309.00
Stationery and cards	54.00
	1983
Functions	$ 507.33
Dues	240.20

The expenses claimed as functions are for the costs of entertainment in connection with a change-of-command ceremony. Petitioners claim that the costs of the change-of-command functions qualify as ordinary and necessary business expenses deductible under section 162. The respondent contends that these expenses are voluntary personal expenses that are disallowed under section 262. n2

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n2 The parties have stipulated that section 274 is not at issue in this case.

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The parties have stipulated that the change-of-command ceremony and attendant receptions are customs and traditions of the Marine Corps. The actual change of command [*313] consists of a formal ceremony in which the outgoing commanding officer conveys the unit's flag to the incoming commanding officer. The change-of-command ceremony is an official function: the troops are in formation, [**5] there is a band, and attendance is mandatory.

Pursuant to the customs and traditions of the Marine Corps, petitioners hosted a party at their home for guests the night before the ceremony. The cost of this party was $244.37. Directly after the change of command, a reception was held at the Officers' Club. n3 The guest list was composed according to strict Marine Corps protocol, and petitioner held scant authority over the nature and time of the entertainment. Petitioners paid $1,064.63 for the reception. Although the change-of-command receptions are characterized by the Marine Corps as “official entertainments” and all commanding officers are required to engage in official entertaining in the performance of their duties, n4 the receptions are not mandated by specific regulations or orders, and the amounts spent for such entertainments are not reimbursed by the Marine Corps.

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n3 Similar expenditures were made for a change of command in 1983, but the parties have agreed that the facts surrounding the Oct. 15 change of command are illustrative of the issues before us.

n4 A memorandum written by Commanding General K.A. Smith to commanding and executive officers concerning the conduct of official entertainment sets forth the functions of petitioner's command:

1. As a function of Command, all Commanding Officers and Executive Officers are required from time to time to participate and engage in official entertaining in the performance of their duties. Although no government funds are available to reimburse officers for personal funds expended in completing these duties, they must, nevertheless, be carried out in a professional and appropriate manner.

2. Whether the entertainment is official must be determined on a case-by-case basis; however, as a function of Command several types of entertainment expenses are deemed necessary and clearly qualify as official. They are: Changes of Command, entertainment of visiting dignitaries—both military and civilian, representing the Command within the civilian community, and representing your Command at official functions.

[Emphasis supplied.]

----------End Footnotes---------- [**6]

On the return of 1983, Col. Fogg also claimed the following deductions:

Organization	Amount
Blue Angels Association	$ 25.00
Officer's Club	132.50
Squadron Officers Fund	82.70
Total	240.20

[*314] These expenses also were incurred pursuant to customs and traditions of the Marine Corps, but not mandated by specific orders.

OPINION

1. Moving Expenses

Section 217 provides in pertinent part as follows:

SEC. 217(a). Deduction Allowed. –There shall be allowed as a deduction moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work.

(b) Definition of Moving Expenses. –

(1) In general. –For purposes of this section, the term "moving expenses‖ means only the reasonable expenses—

(A) of moving household goods and personal effects from the former residence to the new residence * * *

Neither the legislative history, the statute itself, nor the regulations suggests that the words "personal effects" should be given other than their commonly understood meaning. Webster's Dictionary defines personal effects as property [**7] appertaining to one's person and having a close relationship thereto. Webster's Third New International Dictionary (1981). Black's Law Dictionary describes personal effects as articles associated with a person or possessor, having a more or less intimate relation to such person; "effects" meaning movable or chattel property of any kind. Black's Law Dictionary (5th ed. 1979).

In Aksomitas v. Commissioner, 50 T.C. 679 (1968), the taxpayer attempted to deduct under section 217 expenses incurred in an unsuccessful attempt to move Tradewinds, a 45-foot, 13 1/2-ton diesel yacht that was unseaworthy and in a state of disrepair, from Connecticut to Florida. The taxpayer had never used the yacht, and made no attempt to move it until more than 2 years after he had moved his family to the new residence. Thus, we found the yacht had little, much less intimate, association with the taxpayer at the former residence and was not a "personal effect" under section 217. Respondent contends that our opinion in Aksomitas is applicable here. We do not agree because that [*315] opinion does not hold as a matter of law, that no boat can be a personal effect. [**8] Rather, it seems clear that the question is one of fact that must be decided from a consideration of all of the particular circumstances of each case.

In contrast to the situation in Aksomitas, petitioners were intimately associated with their boat. The record clearly reflects that they owned and frequently used the boat for 4 years prior to the move, and they lived on it for 2 weeks immediately prior to their departure from Florida and for 9 weeks immediately following their arrival in South Carolina. Furthermore, numerous personal effects were maintained on board, including kitchen utensils, deck chairs, life preservers, and a refrigerator. It is clear, therefore, that unlike the yacht in Aksomitas, the boat in this case was intimately related to petitioners and their life style, and we find that it is a "personal effect" of petitioners under section 217.

2. Entertainment

Section 162(a) provides that deductions shall be allowed for "all ordinary and necessary expenses paid or incurred * * * in carrying on any trade or business." While the language of the statute seems straightforward, many gremlins of case law lurk beneath the surface, and, indeed, Mr. Justice Cardozo [**9] remarked 55 years ago that "To attempt to harmonize them would be a futile task." Welch v. Helvering, 290 U.S. 111, 116 (1933). The passage of time has not diminished that task, and we do not have the hubris to attempt it here. With those gremlins in mind, however, it is important to recall that the general thrust of section 162(a) is to allow deductions for current business expense while section 262 disallows "personal, living, or family expenses." The tension between these sections is reflected also in section 162(a) by two conspiring phrases -- a "necessary" expense and "incurred" in carrying on a "business."

In examining this question, we are guided by United States v. Gilmore, 372 U.S. 39 (1963). n5 The Court set the stage, as we have done (372 U.S. at 45):

[*316] A basic restriction upon the availability of a * * * [section 162(a)] deduction is that the expense item involved must be one that has a business origin. That restriction not only inheres in the language of * * * [section 162(a)] itself, confining such deductions to "expenses * * * incurred * * * in carrying on any trade [**10] or business," but also follows from * * * [section 262], expressly rendering nondeductible "in any case * * * personal, living, or family expenses." * * *

The question in United States v. Gilmore, supra, was the proper test to be applied in resolving the tension between section 162(a) or 212 and section 262 where the consequences of the action for which the expenses were incurred also affected business interest. The Court concluded (372 U.S. at 49):

we resolve the conflict among the lower courts * * * in favor of the view that the origin and character of the claim with respect to which an expense was incurred * * * is the controlling basic test of whether the expense was "business" or "personal * * *."

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n5 United States v. Gilmore, 372 U.S. 39 (1963) involved a deduction for legal expenses under section 212. The Court, however, recognized that secs. 212 and 162(a) stand in pari materia with respect to the personal versus business analysis. 372 U.S. at 46.

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It may be argued, and, indeed, this may be the basis of respondent's position, that the "origin and character" of any entertainment expense of this nature by an employee is essentially social or personal because he cannot show a direct relationship to a specific business activity. But we have not taken such a narrow view of an employee's deductible expenses under section 162(a). See Walliser v. Commissioner, 72 T.C. 433, 437 (1979), and cases cited therein.

Petitioners, on the other hand, seem to take the position that the expenses are deductible simply because they were incurred by the dictates of the customs and traditions of the military. This argument also states too much. The military life is multifaceted in that it has business and social or personal aspects, both of which are steeped in traditions and customs. For example, there are social functions where, by custom and tradition, spouses are required to be present. Expenses of a spouse in attending the function may be incurred. We do not believe, however, that essentially personal expenses, such as for formal dress, would be rendered deductible by the custom and tradition requiring formal [**12] dress. Compare Hynes v. Commissioner, 74 T.C. 1266, 1289-1292 (1980); Drake v. Commissioner, 52 T.C. 842 (1969). See also Preston v. Commissioner, T.C. Memo. [*317] 1961-250. This however, does not mean that the requirement of an expenditure by "customs and traditions" may not be relevant. But, an inherently personal expense cannot be "converted into a business expense by a formalistic requirement of his employer that they be incurred." Cf. Noland v. Commissioner, 269 F.2d 108, 113 (1959), affg. a Memorandum Opinion of this Court.

Rather, as already stated, the correct focus is on the nature of petitioner's business and the relationship between that business and the circumstances that give rise to the expense. In this regard, we have recognized that a military officer is engaged in a trade or business. Carlisle v. Commissioner, 37 T.C. 424, 429 (1961); Howard v. Commissioner, 16 T.C. 157, 161 (1951), affd. 202 F.2d 28 (9th Cir. 1953). n6 See also Noland v. Commissioner, 269 F.2d at 111. [**13] Furthermore, we have no difficulty in finding that the origin and character of the events or circumstances that give rise to the expenditures in question are directly related to petitioner's trade or business of being a military officer. The expenses directly flowed from a business ceremony in which petitioner was invested with the command of his unit. Compare Feldman v. Commissioner, 86 T.C. 458, 465 (1986) ("the predominant character of the reception was that of a personal and family celebration.")

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n6 The result we reached in Howard v. Commissioner, 16 T.C. 157 (1951), has not withstood the test of time (see United States v. Gilmore, supra at 51 n. 20), but our analysis of this point has not been questioned.

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Even if a direct relationship between an expense and the taxpayer's business is established, however, there are other questions to be answered: were the expenses –ordinary and necessary.‖ The phrase contains dual requirements [**14] —i.e., it must be both "ordinary" and "necessary." See, e.g., Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 354 (1971). Moreover, both terms are words of art. In Commissioner v. Tellier, 383 U.S. 687, 689-690 (1966), the Court stated:

The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible, and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset. * * *

[*318] Respondent, however, does not argue that these expenses were not ordinary. Rather, respondent contends that the expenses were not "necessary." In Commissioner v. Tellier, supra, the Court also addressed this issue (383 U.S. at 689):

Our decisions have consistently construed the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the taxpayer's business."

Respondent contends that in order for the expenses to be "necessary," [**15] petitioner must prove that, as an employee, "his employer required him to bear the expense without reimbursement." See, e.g., Fountain v. Commissioner, 59 T.C. 696, 708 (1973). We recognize that the line of cases suggesting this result has not been without critics. n7 We do not believe, however, that it is necessary to revisit this area in the context of this case. It is quite clear that these expenses were required by Col. Fogg's employer. We noted in Pollock v. Commissioner, 10 B.T.A. 1297, 1299 (1928), in which we held unreimbursed entertainment expenses of a naval officer to be deductible:

If * * * [petitioner] had failed to extend courtesies to a foreign official, he probably would not have been demoted, but he would have been liable to being summarily detached for failing in official courtesy, his record would have been impaired, and it probably would have resulted in his loss of future promotion.

Thus, while the officer in Pollock may not have been under a direct order, we recognized that one need not be threatened with a court martial in order for an expenditure of a military officer to be considered "necessary." [**16] Clearly a ‒hard-headed businessman‖ would have incurred those expenses. See Cole v. Commissioner, 481 F.2d 872, 876 (2d Cir. 1973), affg. a Memorandum Opinion of this Court. Col. Fogg faced the same situation, and we have no difficulty in arriving at the same conclusion. n8

- - - - - - - - - - - - - - - - - -Footnotes- - - - - - - - - - - - - - - - - -

n7 See, e.g. Davis v. Commissioner, 38 T.C. 175, 184-186 (1962) (Raum, J., dissenting); Wolfman, "Professors and the 'Ordinary and Necessary' Business Expense," 112 U. Pa. L. Rev. 1089 (1964). See also Brief for the Appellee, filed by the Tax Division, Department of Justice, in Peter Stemkowski, Appellant v. Commissioner of Internal Revenue, Appellee, No. 81-4194, 2d Cir., at 46-47. This criticism is primarily directed to the situation where the expense is not required by the employer. That is not the situation with which we are faced here.

n8 Furthermore, this Court will generally follow the law of a circuit to which an appeal would lie, even when our precedent is to the contrary. Golsen v. Commissioner, 54 T.C. 742, 756-758 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971). In Stemkowski v. Commissioner, 76 T.C. 252, 307 (1981), we upheld the disallowance of certain employee business expenses on the ground that they were not required by the employer. Both the Second and the Fourth Circuits reversed our holding. Stemkowski v. Commissioner, 690 F.2d 40, 47 (2d Cir. 1982); Hanna v. Commissioner, 763 F.2d 171, 172 (4th Cir. 1985). The venue for an appeal in this case is in the Fourth Circuit and, it would appear that the Court has refused to adopt the rule that "to be necessary" the expense must be required by the employer. Thus, we would follow the precedent set out in Hanna v. Commissioner, supra.

----------End Footnotes---------- [**17]

[*319] Petitioners are entitled to deduct their costs of the entertainment in connection with the change-of-command ceremony.

3. Miscellaneous Deductions

Petitioners claimed deductions on their 1982 tax return for stationery and calling cards in the amount of $54. On their 1983 return, they claimed the following deductions:

Blue Angels Association	$ 25.00
Officers' Club	132.50
Squadron Officers' Fund	82.70

Petitioners' basic argument with respect to these items is that they were required by the "customs and traditions" of the Marine Corps. As already stated, such circumstances alone will not satisfy the "incurred in a trade or business" requirement of section 162(a). We note also that many of these items are inherently suspect and may have their origins in essentially social aspects of military life—e.g., calling cards, stationery, officers' club dues. n9 We are aware that calling cards and personal stationery are required at or for certain military functions, but we are also aware that these items are used on occasions that have the origins in purely personal or non-business affairs—weddings, funerals, etc. Similarly, we are aware that an officers' club, [**18] like any social club, may be used for business entertainment. On the other hand, the officers' club is also the center of social life for many officers and their families on military posts and bases. Petitioners had the burden of proof. Welch v. Helvering, supra. In view of our previous discussion, therefore, it was their burden to establish that the origin and character of these expenditures have a direct relationship to Col. Fogg's business. Petitioners offered no evidence [*320] on these critical points and, accordingly, we sustain respondent's disallowance of these items. n10

----------Footnotes----------

n9 There are, of course, other restrictions on deductions for club dues. See sec. 274(a). In light of our disposition of the issue under sec. 162(a), we need not consider those provisions.

n10 We do not consider petitioners' claim that they attended five official functions at the club sufficient to carry this burden. Their burden also includes establishing that the club was not substantially used for non-business purposes. There is no evidence with regard to this question.

- - - - - - - - - - - - - - - - -End Footnotes- - - - - - - - - - - - - - - - - [**19]

We also have difficulty with the payment to the Blue Angels Association. The Blue Angels Association is comprised of present and former pilots who fly or have flown with the Blue Angels Squadron, a specialized unit of highly skilled pilots. The Association was formed "to preserve and maintain the high standards, customs, and traditions" of the Blue Angels and it maintains a fund donated by members and others for these purposes. Our problem is that we have no information as to how the Association operates. On one hand, it may be completely a social or fraternal type organization with limited membership. On the other hand, it may be a business group devoted to the exchange of aeronautical information. Both types of organizations would fit within the description given us. But, the tax implications of the different organizations would be different. Compare Noland v. Commissioner, supra. Given this uncertainty, we must find that petitioners have failed to carry the burden of proof that this expenditure was directly related to Col. Fogg's business of being a military officer.

The contribution to the squadron fund is a different matter. This is a [**20] fund, maintained within a military unit by donations from the unit officers, that is used to purchase mementos, such as unit emblems, for departing personnel, to pay for flowers for personnel in hospitals, etc. There are no appropriated funds for these purposes. Col. Fogg, as an officer in the unit, was expected to make contributions to the fund, and, as with the expenditures for entertainment, if he refused to contribute to the fund his career might have been jeopardized. Moreover, respondent does not suggest that Col. Fogg received, or would receive, any substantial personal benefit from the fund. We believe that the origin and character of this expense is clearly related to Col. Fogg's business of being a military officer and that this expense was appropriate and helpful to that career.

Decision will be entered under Rule 155.

CHAPTER K

TAX CREDITS

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. Tax Forms: 1040, W-2, 2441, Schedule M, Schedule R, Child Tax Credit Worksheet in 1040 instructions; Form 8812, 8839, 8910, 8936, 8880, 5695, 5405, EIC Worksheet A & B, EIC Tables, 8863, 1098-T.

B. Internal Revenue Code of 1986, as amended (I.R.C.)

C. Federal Income Tax Regulations (Treas. Reg.)

D. IRS Publications:

1. Pub. 17, Your Federal Income Tax

2. Pub. 503, Child and Dependent Care Expenses

3. Pub. 524, Credit for the Elderly or Disabled

4. Pub. 596, Earned Income Credit

5. Pub. 970, Tax Benefits for Education

6. Pub. 972, Child Tax Credit

II. INTRODUCTION.

A. Taxpayers, whether or not in business, may qualify for one or more personal credits.

B. A credit is a dollar-for-dollar reduction of the taxpayer's tax liability.

III. TYPES OF CREDITS.

A. A ***refundable credit*** can be greater than the tax owed. Taxpayers not only can have their tax reduced to zero, but they can also receive a refund of the excess credit.

B. A ***nonrefundable credit*** can also be greater than the tax, but the nonrefundable credit can only reduce tax liabilities to zero. Taxpayers do not receive a refund for any excess nonrefundable credit.

IV. FOREIGN TAX CREDIT (FORM 116). THIS MATERIAL WILL BE COVERED DURING THE CLASS ON FOREIGN TAX ISSUES.

V. CHILD AND DEPENDENT CARE CREDIT (FORM 2441).

A. A ***nonrefundable credit*** is allowed for a portion of qualifying child or dependent care expenses paid for the purpose of allowing a taxpayer (and the taxpayer's spouse if married filing a joint return) to be gainfully employed. I.R.C. § 21.

B. Qualifying Person. To be eligible for the credit, the taxpayer must pay for the care of a qualifying individual, which includes:

1. Dependents under age 13 for whom a dependency exemption may be claimed by the taxpayer.

2. In the case of a dependent child under the age of 13 where the parents are divorced or legally separated and lived apart during the last 6 months of the year, <u>only the custodial parent can claim the</u>

child and dependent care credit. This is the case even if the custodial parent does not claim the dependency exemption for that child.

3. Any other person who is physically or mentally incapable to care for themselves and who lived in the taxpayer's principal place of abode for 1/2 of the tax year. In this case, the taxpayer must either be able to claim the person as a dependent or be able to claim the person as a dependent except for the fact that the person had income exceeding the exemption amount.

4. A spouse who is physically or mentally unable to care for self and has the same principal place of abode as the taxpayer for 1/2 the tax year.

5. The status of an individual as a qualifying person is determined on a daily basis. For example: if a dependent child turns 13 on 1 July of the tax year, that child was a qualifying person from 1 Jan - 30 June of the tax year.

   A qualifying person who was born or died in 2016 is treated as having lived with the taxpayer for all of 2016 if the taxpayer's home was the qualifying person's home the entire time he or she was alive in 2016.

C. Gainful Employment:

1. Expenses must be employment related enabling the taxpayer to be gainfully employed, or in the active search for gainful employment.

2. The expense is not employment related just because it is paid or incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed.

3. A taxpayer's spouse is deemed to be gainfully employed during each month that he or she is a full-time student at an educational institution or some part of each of five calendar months during 2016.

4. Volunteer work, even if for nominal consideration, is never gainful employment.

5. Gainful employment can be self-employment and can be done in the home of the taxpayer.

6. Part-time work. If the taxpayer works only part time, the taxpayer must allocate expenses for dependent care between the days of work and the days not worked.

   a. A day where the taxpayer works at least one hour is a day of work.

   b. If the taxpayer must pay dependent care expenses on a periodic basis including both days of work and non-work days, then no requirement to allocate.

D. Qualifying expenses include:

1. Expenses paid for household services and for the care of a qualifying individual.

   a. Not all expenses are for the individual's care.

   b. Amounts paid for food, lodging, clothing, and education are not for the care of the individual.

2. Services outside the home qualify if they involve the care of a qualified child, disabled spouse, or dependent who regularly spends at least eight hours a day in the taxpayer's home.

3. Payments to a relative also qualify for the credit unless the taxpayer claims a dependency exemption for the relative or if the relative is the taxpayer's child and is under age 19.

4. No credit is allowed for expenses to send a child or other dependent to an overnight camp. Day-camp fees are qualified for this credit.

5. Tutoring and summer school expenses are not qualifying expenses because they are not employment related.

6. The total cost of sending a child to a school can be counted only if the child is in a grade level below the first grade, and the amount paid for schooling is incident to and cannot be separated from the cost of care. If the child is in the first grade or higher, or if the cost of schooling can be separated, the taxpayer must divide the total cost between the cost of schooling and the cost of care. Only the cost of care can be counted.

7. Transportation costs can be qualified expenses if the dependent care provider transports the qualifying child to or from the place where the care is provided.

8. The fees paid to an au pair agency are qualified expenses.

E. Amount and limitations of the credit:

1. The credit is based on a percentage of the lesser of actual expenses or the maximum employment-related expenses of $3,000 if one qualifying child or dependent or $6,000 if two or more qualifying children or dependents.

2. Work-related expenses are reduced by any tax-free reimbursements under a qualified employer dependent care program. These would be indicated on Form W-2, Box 10.

Example: Molly has one child, incurred dependent care expenses during the year of $3,000, and received $1,500 reimbursement of child care costs from her company's dependent care assistance plan. The amount of expenses eligible for the tax credit is reduced to $1,500 ($3,000-$1,500).

3. Qualifying employment related expenses are considered in determining the credit only to the extent of earned income (wages, salary, etc.).

4. Married taxpayers usually must both work in order to claim the credit. For married taxpayers, expenses are limited to the earned income of the lower earning spouse.

Example: If taxpayer earns $18,000/year and spouse earns $5,400/year and credit is claimed for two children, the maximum work-related expenses for purposes of calculating the credit is $5,400 instead of $6,000.

5. However, if a nonworking spouse is physically or mentally incapable of caring for himself or is a full-time student at an educational institution for at least five calendar months during the year, the law assumes an earned income for each month of disability or school attendance of $250 if there is one qualifying child or dependent or of $500 if there are two or more.

   a. To be a full time student under this rule, the 5 months do not have to be consecutive.

   b. An institution that only offers internet classes is not a qualifying institution and therefore the spouse could not use those classes for determining full time student status. However, if the institution also offers traditional class instruction, but the spouse is taking internet classes then the institution does qualify.

6. In 2016, the credit and AGI amounts are equal to:

   a. 35% of employment related expenses for taxpayers with AGI of $15,000 or less.

   b. For taxpayers with AGI between $15,000 and $43,000, the credit is reduced by one percentage point of each $2,000 of AGI over $15,000.

   c. For taxpayers with AGI over $43,000, the credit is 20%.

d. Allowable credit (Note: Updated amounts for 2016 were not available prior to production of this Deskbook and may vary slightly from this table):

Adjusted Gross Income	Credit %	Maximum Credit	
		One Dependent	Two or More Dependents
$15,000 or less	35%	$1,050	$2,100
15,001 – 17,000	34%	1,020	2,040
17,001 – 19,000	33%	990	1,980
19,001 – 21,000	32%	960	1,920
21,001 – 23,000	31%	930	1,860
23,001 – 25,000	30%	900	1,800
25,001 – 27,000	29%	870	1,740
27,001 – 29,000	28%	840	1,680
29,001 – 31,000	27%	810	1,620
31,001 – 33,000	26%	780	1,560
33,001 – 35,000	25%	750	1,500
35,001 – 37,000	24%	720	1,440
37,001 – 39,000	23%	690	1,380
39,001 – 41,000	22%	660	1,320
41,001 – 43, 000	21%	630	1,260
43,001 and over	20%	600	1,200

Example: SGT Taxpayer (who had an AGI of $15,678) incurred $2,400 in child care expenses for a qualifying child. SGT Taxpayer's child care credit is:

$2,400 (lesser of choices is actual expenses)
x 34% (percent from chart)
$ 816 (allowable child care credit)

F. Other Qualifying Requirements:

1. The taxpayer must identify the care provider on the taxpayer's tax return in Part I of Form 2441.

   a. Must disclose the name, address, and taxpayer ID number (SSN or ITIN for individuals) of care provider.

   b. Form W-10, Dependent Care Provider's Identification and Certification, can be used to get the necessary information from the provider. (Or get a copy of the care provider's driver's license, SS card, or business letterhead or invoice.)

   c. Incomplete or incorrect information: care providers can be penalized for issuing incorrect Forms W-10. Taxpayer must show due diligence in acquiring this information.

2. Married taxpayers must file a joint return to get the credit.

3. Payments to relatives qualify but there are some restrictions.

   a. Cannot claim expenses paid to anyone for whom the taxpayer can claim a dependency exemption.

   b. Cannot claim expenses paid to someone who is the taxpayer's child and under the age of 19.

   c. Cannot claim expenses paid to anyone who was the spouse of the taxpayer at any time during the tax year.

   d. Cannot claim expenses paid to the parent of the taxpayer's child who is under the age of 13.

G. The child care credit is computed on Form 2441 (or Schedule 2 for Form 1040A filers). The amount of the child care credit will be transferred from Form 2441, to Form 1040.

VI. CREDIT FOR THE ELDERLY (SCHEDULE R).

A. A ***nonrefundable credit*** is allowed for taxpayers who are over age 65 or under age 65 and permanently and totally disabled. I.R.C. § 22, see also IRS Pub. 503.

B. A 15% tax credit for the elderly or the permanently and totally disabled applies to citizens or residents who are:

1. 65 years of age before the close of the tax year, or

2. Under age 65, are retired on disability, and were permanently and totally disabled when retired.

C. Married taxpayers must file a joint return to claim the credit, unless the spouses live apart throughout the tax year.

D. Income Limits. Many elderly taxpayers are not eligible for this credit because of the income limitations. A taxpayer cannot take the credit if the amount on Form 1040, line 37 (Adjusted Gross Income) is $17,500 or more ($20,000 if married filing jointly and only one spouse is eligible for the credit; $25,000 if married filing jointly and both spouses are eligible; $12,500 if married filing separately).

Income Limits for the Credit for the Elderly or the Disabled

IF you are . . .	**THEN** you generally **cannot** take the credit if:	
	The amount on Form 1040A, line 22, or Form 1040, line 38, is . . .	Or you received . . .
1. Single, head of household, or qualifying widow(er) with dependent child	$17,500 or more	$5,000 or more of nontaxable social security or other nontaxable pensions, annuities, or disability income
2. Married filing jointly and only one spouse is eligible for the credit	$20,000 or more	$5,000 or more of nontaxable social security or other nontaxable pensions, annuities, or disability income
3. Married filing jointly and both spouses are eligible for the credit	$25,000 or more	$7,500 or more of nontaxable social security or other nontaxable pensions, annuities, or disability income
4. Married filing separately and you lived apart from your spouse for all of 2015	$12,500 or more	$3,750 or more of nontaxable social security or other nontaxable pensions, annuities, or disability income

E. How it works (using Schedule R):

1. Start with AGI, then subtract the following amount from AGI:

   a. $10,000, if married filing jointly;

   b. $7,500 if single, head of household, qualifying widow(er); or

   c. $5,000, if married filing separately.

2. Take this result and divide by two. Add to this result any nontaxable social security benefits and nontaxable veterans' pensions or any other pensions or disability benefits that are excludable from income.

3. From this result, subtract:

   a. $7,500 in the case of a joint return where both are eligible individuals;

   b. $5,000 in the case of a single return or a joint return where only one individual qualifies; or

   c. $3,750 in the case of a married individual filing a separate return.

4. This result is multiplied by 15% (Schedule R, line 20). The Credit is the lesser of this result (i.e., line 20) or the maximum eligible credit.

   Note, however, that this is a nonrefundable credit, and thus cannot reduce the tax liability below zero. The resulting credit is entered on Form 1040, line 54, other credits.

VII. EDUCATIONAL CREDITS. (FORM 8863).

A. American Opportunity Tax Credit. I.R.C. §25A(i), see also IRS Pub. 970.

1. The American Opportunity Tax Credit is an expansion of the Hope Scholarship under § 25A(b)(1); is also known as the Modified Hope Credit. The American Opportunity Tax Credit expires on December 31, 2017.

2. A ***partly refundable*** tax credit that was extended by The American Taxpayer Relief Act of 2012 for tax years through 2017.

3. The maximum American Opportunity Tax Credit allowable is $2,500, consisting of 100% of the first $2,000 of qualified tuition and related expenses plus 25% of the next $2,000 of qualified expenses.

4. A taxpayer is allowed a tax credit for money spent on qualified tuition and related expenses during the first four (4) years of a student's post-secondary school education (**a per student credit**). I.R.C. §25A(i)(1)(A) and §25A(i)(2).

   a. The student must carry at least half of the normal full-time workload for the course of study the student is pursuing.

   b. Academic period includes the tax year plus the first three months of the next year. So, expenses for the spring semester paid in December count for the year.

5. Income Limit. American Opportunity Credit has higher income phaseouts than other education credits. For 2016, the American Opportunity Tax Credit is phased out at modified AGI between $160,000 and $180,000 for MFJ, and modified AGI between $80,000 and $90,000 for single. See Rev. Proc. 2014-61.

6. Portion of the American Opportunity Credit is **refundable**.

a. Up to 40% of the American Opportunity Credit is refundable.

b. Other credits and the income phase out work first before the refundable rules for this credit apply.

(1) Example: Married Filing Joint returns are eligible for a $2,500 American Opportunity Credit with a MAGI of $157,000. There is no phase out of the Credit, however, if other credits are claimed they will be applied against the taxpayer's tax liability first. If the taxpayer's tax liability is reduced to $0, then the taxpayer will qualify for a refundable American Opportunity Credit of $1,000. [$2,500 x .40 = $1,000].

(2) Example: Same example as above, except MAGI is $170,000 and therefore the phase out applies. At this MAGI level, the taxpayer is phased out of 50% of the credit, thereby lowering the American Opportunity Tax Credit to $1,250. The credit is refundable up to 40% of the allowable credit, thus making $500 of the American Opportunity Credit a refundable credit. [$2,500 - $1250 = $1,250 x .40 = $500].

B. Lifetime Learning Credit. I.R.C. § 25A.

1. The Lifetime Learning Credit is a nonrefundable credit, available for any level of higher education (both credit and noncredit courses). The Lifetime Learning Credit differs from the American Opportunity credit in that it covers a broader period and range of educational courses. Whereas the American Opportunity credit applies only to the first four years of post-secondary education, the Lifetime Learning Credit applies to expenses for undergraduate, graduate, and continuing education courses. Expenses for courses of instruction at an eligible institution *to acquire or improve job skills* that would not qualify for the American Opportunity credits qualify for the Lifetime Learning Credit. I.R.C. § 25A(c)(2)(B)

2. The Lifetime Learning Credit is allowed for 20% of first $10,000 (= $2,000) of qualified education expenses paid by the taxpayer. The maximum credit is $2,000 per return regardless of the number of eligible students. There is no limit on the number of years the credit can be claimed for each student.

3. Double Benefit Restriction. Generally, a person who is eligible for the American Opportunity Credit is not entitled to the Lifetime Learning Credit.

   a. Unlike the American Opportunity Credit, which is available for the qualifying expenses of each qualifying student, the Lifetime Learning credit is available only per taxpayer.

   b. For example, a joint filing couple with two children could claim no more than a $2,000 Lifetime Learning credit, even if each family member is a qualifying student with qualifying expenses.

   c. Claiming more than one education benefit. A taxpayer can claim more than one education benefit in a tax year <u>provided the same qualified expenses are not used to claim more than one benefit</u>.

4. Income Limit. The Lifetime Learning Credit in Tax Year 2016 is phased out ratably for taxpayers with MAGI from $55,000 to $65,000 ($111,000 to $131,000 for married filing jointly).

C. Qualified Expenses For Education Credits:

1. Include expenses paid by the taxpayer on behalf of himself, his spouse, or any dependent of the taxpayer for which the taxpayer is allowed the dependency exemption.

2. Qualified tuition and related expenses include tuition, fees, and expenses for course related books, supplies, and equipment only if they <u>MUST</u> be paid to the institution as a condition of enrollment or attendance at a post-secondary educational institution eligible to participate in the federal student loan program.

3. They do not include the costs of books, room and board, transportation, etc.

4. Expenses for courses involving sports, games, or hobbies do not qualify unless they are part of the student's degree program.

5. Nonacademic fees, such as student activity fees, athletic fees, insurance expenses, do not qualify. I.R.C. § 25A(f). As noted above, student-activity fees are included in qualified education expenses only if the fees must be paid to the institution as a condition of enrollment or attendance.

6. The taxpayer must reduce qualified tuition and related expenses by tax free scholarships, Pell grants, employer-provided educational assistance, veteran's benefits, and other tax-free payments. However, qualified amounts do not have to be reduced by amounts paid by gift, bequest, devise, or inheritance. I.R.C. § 25A(g)(2). In addition, no credit is allowed for any expense for which an income tax deduction is allowed. I.R.C. § 25A(g)(5).

7. **NOTE for American Opportunity Credit ONLY:** Qualified expenses includes books, supplies and equipment whether or not the materials are purchased from the educational institution.

D. For each eligible student, a taxpayer may claim only one of the education credits in a single tax year. I.R.C. § 25A(c)(2).

1. Must be allowed to claim a dependency exemption for a child in order to take the American Opportunity, or Lifetime Learning Scholarship credits (IRC § 25A(f)(1)(A)(iii)).

2. An eligible student is a person that can be claimed as a dependency exemption. It generally includes unmarried children under age 19 or who is a full-time student under 24 if the taxpayer supplies more than half the child's support for the tax year. If a dependency exemption for an individual is allowed to another taxpayer, the dependent cannot claim the credit, and qualified tuition and expenses paid by the dependent during the tax year will be treated as paid by the taxpayer who is allowed the dependency exemption. I.R.C. § 25A(g)(3).

E. Taxpayers who are married (within the meaning of I.R.C. § 7703) are not entitled to any credit unless they file a joint return. Married taxpayers incurring qualified expenses must file a joint income tax return in order to claim the educational tax credits. No credit under I.R.C. § 25A is allowed for married taxpayers filing separate returns. In order to claim the credit, the taxpayer must include the student's name and social security number on his or her return.

F. Claiming the Education Credits:

1. Complete Form 8863.

2. The amount on Form 8863 is the amount of the Education credit transferred to Form 1040.

VIII. RETIREMENT SAVINGS CONTRIBUTION CREDIT. AKA: THE SAVER'S CREDIT (FORM 8880)

A. A ***nonrefundable*** credit created by The Economic Growth and Tax Relief Reconciliation Act of 2001. The Pension Protection Act of 2006 (109 P.L. 280) made the Saver's Credit permanent. Provides a credit for contributions made to certain retirement accounts

B. The Saver's Credit applies to individuals with AGI up to $30,750 , heads of household with AGI up to $46,125, and married couples with AGI up to $61,500.

1. Taxpayer must be 18 years old or older by the end of the tax year, not a full time student, and not claimed as dependent on someone else's tax return.

C. The maximum annual contribution eligible for the credit is $2,000 per person. The amount of any contribution eligible for the credit must be reduced by any amount of taxable distribution received by the taxpayer from any such plan during the testing period.

1. The Testing Period: is the year for which the credit is claimed, the period in the following year thru the due date (with extensions) for

filing the return for the earlier year, and the two tax years preceding the year for which the credit is claimed.

2. This applies to Roth distributions unless it is rolled over.

3. Example: Husband makes a $3,000 contribution to his IRA and Wife makes a $500 contribution to her IRA. The annual contribution eligible for the saver's credit is $2,500 ($2,000 from his contribution and $500 from hers).

4. Reduction example: Husband contributes $3,000 to TSP in 2013 but took a $900 IRA withdrawal in 2010 and a $500 withdrawal in 2011. No rollover of the IRA withdrawals. Only $1,600 of the TSP contribution is eligible for the saver's credit because the withdrawals must be deducted from the contribution.

D. Types of Contributions eligible include 401(k) plans, Thrift Savings Plan contributions, IRA contributions (both traditional and Roth), SEPs, SIMPLE IRA plans, and 403(b) annuity.

E. The saver's credit is in addition to any other tax benefits of the contribution.

F. The credit is 50%, 20% or 10% of qualified contributions to retirement plans. What percentage the taxpayer receives depends on filing status (MFJ – married filing jointly; HoH – Head of Household) and AGI as shown here:

CREDIT RATE	MFJ	HoH	OTHERS
50%	Up to $36,500	Up to $27,375	Up to $18,250
20%	$36,500 – $39,500	$27,375 – $29,625	$18,250 – $19,750
10%	$39,500 – $61,000	$29,625 – $45,750	$19,750 – $30,500

G. Claiming the Credit.

1. Determine the filing status, and AGI of the taxpayer, and then determine the contribution amount eligible for the credit, consult

the chart and determine the credit rate for the taxpayer, multiply the eligible contribution amount by the applicable credit rate.

2. Complete Form 8880, the credit amount goes on the 1040.

IX. RESIDENTIAL ENERGY CREDITS. (FORM 5695)

A. The Energy Tax Incentive Act of 2005 (109 P.L. 58) added section 25C to the Internal Revenue Code, providing a ***nonrefundable*** credit for taxpayers who install energy efficient improvements to their residence and I.R.C. § 25D to the Internal Revenue Code, providing a ***nonrefundable*** credit for taxpayers who purchase energy efficient property for their residence.

B. I.R.C. § 25C, Non-Business Energy Property Credit, allows a credit of 10 percent of the cost of certain energy saving property that you added to your main home ***before 2015*** (the credit was set to expire in 2014 but was extended, retroactively, through December 31, 2014, thus allowed for tax years 2005 through 2014). This includes the cost of qualified insulation, windows, doors, and roofs.

1. Credit Limits: Maximum credit is $500 **LIFETIME**; $200 limit for windows.

2. Your main home must be located in the U.S. to qualify for the credit.

3. Note: Not all energy-efficient improvements qualify. Taxpayers will need to have the manufacturer's credit certification statement, usually available on the manufacturer's website or with the product's packaging.

C. Section 25D, Residential Energy Efficient Property Credit, allows a credit of 30% of the cost of alternative energy equipment installed on or in your home *before 2017*. Qualified equipment includes solar hot water heaters, solar electric equipment and wind turbines.

1. This property can be installed in the principal residence or the vacation home of the taxpayer, but the property cannot be used to heat a swimming pool or hot tub. (I.R.C. § 25D(e)(3)).

2. Additionally, the cost includes installation and labor costs as well as hardware costs.

3. There is no limit on the amount of credit available for most types of property. If your credit is more than the tax you owe, you can carry forward the unused portion of this credit to next year's tax return.

4. If the credit is justified by the purchase of the energy efficient property, the basis in the property is reduced by the amount of credit allowed. (I.R.C. § 25D(f)).

5. This credit is available through 2016.

D. Claiming the credit.

1. Complete Form 5695, part I for non-business energy property credits under I.R.C. § 25C.

2. Complete Form 5695, part II for any energy efficient property such as solar panels, solar water heaters, or fuel cell power plants under I.R.C. § 25D.

3. Combine the allowable credits from Form 5695 parts I and II and transfer to Form 1040.

X. CHILD TAX CREDIT. (FORM 8812)

A. A credit of $1,000 is allowed in 2016 for each qualifying child. This was a credit that was extended permanently by the American Taxpayer Relief Act of 2012 (however, without inflation adjustments for future years.)

B. A taxpayer may be entitled to a child tax credit for each qualifying child for whom the taxpayer claims an exemption.

C. **Refundable Credit**. This is now a ***refundable credit*** under the 2001 Tax Act. I.R.C. § 24. The Working Families Tax Relief Act of 2004

also accelerated the portion of the child tax credit that is refundable. The child tax credit will first eliminate any federal tax owed.

D. Income excluded due to service in a combat zone under IRC § 112 is treated as earned income for purposes of the refundable child credit.

E. A qualifying child is one who meets the following criteria.

1. The child must be the taxpayer's child (or descendant thereof – by blood or adoption), brother, sister, stepbrother, stepsister, (or descendant thereof), step-child, or foster child of the taxpayer.

2. Lived with the taxpayer for more than half of 2016.

3. The child must not have reached the age of 17 by the end of the tax year for which the credit is sought.

4. A citizen or resident of the United States.

5. The taxpayer must be *allowed* the personal exemption deduction with respect to such child.

   a. The parent that is "allowed a deduction" with respect to such child will be entitled to the credit. Must be allowed to claim a dependency exemption for a child in order to take child tax credit (IRC § 24(c)(1)(A)).

   b. In order to claim the child tax credit, the parent must claim the child as a dependency exemption. The parent claiming the child tax credit must list the child as a dependency exemption on the tax form and include the qualifying child's name and social security number. If the custodial parent waives the dependency exemption, the noncustodial parent gets both the exemption and the child tax credit.

6. The credit will be phased out by $50 for each $1,000 that the taxpayer's modified adjusted gross income exceeds $110,000 in the case of a joint return, $75,000 in the case of an individual who is single, head of household or qualifying widow(er), and $55,000 in

the case of a married individual filing a separate return. (I.R.C. § 24(b)).

7. Claiming the Child Tax Credit:

   a. Taxpayer must provide the name and the identification number on the tax return for each qualifying child.

   b. The amount of the credit calculated on the worksheet is the amount of the child tax credit transferred to Form 1040.

F. Additional Child Tax Credit. I.R.C. § 32(n). Form 8812.

1. A portion of the credit may be refundable under a special formula. It does not affect the total tax credits allowed to the taxpayer. This is the ***refundable*** portion of the ***credit***. Taxpayers may be able to claim the additional credit if any portion of the regular Child Tax Credit was disallowed because tax was reduced to zero before the entire credit was used. The portion of the Child Tax Credit phased out because of AGI cannot be used to claim the additional credit. The additional credit is refundable.

2. After all the other credits are applied according to the stacking rules to reduce the taxpayer's tax liability for the year, then the refundable credits are applied. The refundable credits first reduce the taxpayer's tax liability for the year, and any remaining credit in excess of the tax liability for the year is payable to the taxpayer.

3. The additional child tax credit is the <u>lesser</u> of the unused portion of the regular Child Tax Credit or 15% of the taxpayer's earned income minus $3,000. The amount subtracted from earned income (the threshold) is indexed to inflation and changes tax year to tax year. The American Taxpayer Relief Act of 2012 extended the temporary reduction (to $3,000) through 2017. I.R.C. § 24(d)(1)(B)(i).

4. Claiming the Additional Child Tax Credit:

   a. Taxpayer must provide the name and the identification number on the tax return for each qualifying child.

b. Complete Child Tax Credit worksheet in Form 1040 instructions.

c. The amount of the credit calculated on the worksheet is the amount of the child tax credit transferred to Form 1040.

d. Use Form 8812 to calculate and report the additional child tax credit.

e. If the taxpayer is allowed the additional child tax credit on the Form 8812, carry it to Form 1040, payments section.

XI. ADOPTION CREDIT. (FORM 8839)

A. For 2016 returns, taxpayers may claim a ***nonrefundable tax credit*** for qualified adoption expenses up to $13,460 for each eligible child. I.R.C. § 23(a)(3), Rev. Proc. 2014-61, Rev. Proc. 2015-53. The credit for adoption is a permanent credit under the American Taxpayer Relief Act of 2012.

B. Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees and other expenses which are directly related to the legal adoption of an eligible child.

C. An eligible child is an individual who has not attained the age of 18 as of the time of the adoption or who is physically or mentally incapable of caring for himself.

D. Not available for the adoption of step children or surrogate arrangements.

E. When to claim the credit depends on when the adoption was finalized and whether the child is a US citizen or foreign national.

1. US citizen (or resident alien) child.

a. Expenses in year before adoption final take in the year after expenses paid.

b. Expenses in same year as adoption final take that year.

c. Expenses paid after adoption final take in year paid.

2. Foreign national child.

a. Credit is taken in the year the adoption is finalized.

b. Expenses paid after the adoption is final can be taken in the year paid.

F. The available adoption credit begins to phase out under § 23(b)(2)(A) for taxpayers with modified adjusted gross income in excess of $201,920 and is completely phased out for taxpayers with modified adjusted gross income of $241,920 or more.

G. Parents who adopted a child who has been determined to be special needs by the state or county child welfare agency can claim the maximum credit regardless of whether they have qualified adoption expenses at all.

H. A child with special needs is one who is a citizen, or resident, of the United States or its territories for whom a State has determined:

1. The child cannot or should not be returned to the home of his parents; or

2. The child would not otherwise be adopted without providing adoption assistance because of the child's ethnic background, age, or the presence of factors such as physical or emotional handicaps.

I. The IRS has concluded that adoption assistance payments made by a state to adoptive parents of special needs children are not includable in gross income. Because the payments are in the nature of general welfare, they are not includable in income, and no information reporting is required. I.R.S. Technical Assistance Memorandum, 2000-21-036 (February 15, 2000), available at Tax Note Today, 2000 TNT 104-74 (May 30, 2000).

J. Can exclude up to $13,460 of employer paid adoption expenses from income. Employer-provided adoption benefits are reported on W-2, box 12 with code T.

K. Claiming the Adoption Credit:

1. Complete Form 8839.

2. Transfer the amount of credit allowed from Form 8839 to Form 1040.

L. Carry Forward: 5 year carry forward for unused adoption credit.

XII. EARNED INCOME CREDIT. (SCHEDULE EIC, EIC WORKSHEET)

A. General.

1. The Earned Income Credit (EIC) is a ***refundable tax credit***. Eligible taxpayers can receive a refund for this credit even if they owe no tax and had no income tax withheld. I.R.C. § 32.

2. EIC provides tax relief to low-income workers, including certain workers with no children.

3. Cannot claim the EIC if the taxpayer claims the foreign earned income exclusion. I.R.C. § 32(c)(1)(D).

4. EITC amount now available for taxpayers with 3 qualifying children.

B. Eligible taxpayers that can claim EIC:

1. Married taxpayers who are entitled to a dependency exemption for a qualifying child.

a. Married taxpayers generally must file married filing jointly.

b. Certain married taxpayers who live apart from a spouse need not file a joint return to claim the credit.

2. A custodial parent, even if that parent agrees to allow the noncustodial parent to claim the child as a dependency exemption.

3. Surviving Spouses.

4. Heads of households who maintain a home for a child, adopted child, stepchild, eligible foster child or descendent of a child. (A married child must qualify as a "dependent" for whom the taxpayer is entitled to a dependency exemption.).

5. An individual who does not have a qualifying child may be eligible for the credit if the principal place of residence of the individual is in the U.S. for more than one-half of the tax year, the individual (or the spouse of the individual) is at least age 25 and under age 65 before the close of the tax year, and the individual is not claimed as a dependent by another.

C. Qualifying Tests.

1. Taxpayer with qualifying child(ren) must:

a. Have a qualifying child who lived with the taxpayer in the taxpayer's main home in the U.S. (or overseas if taxpayer is a member of the armed forces stationed overseas) for more than 6 months of the year;

b. File a joint return if married; and

c. Complete and attach Schedule EIC to the tax return.

2. Taxpayer without qualifying child(ren) must:

a. Have main home in U.S. for more than 6 months of the year or be a member of the armed forces stationed overseas;

b. Be at least 25, but under 65 (If filing jointly, either spouse must satisfy age component of test.);

c. File a joint return if married; and

d. Not be a dependent or qualifying child of another taxpayer.

3. The threshold phaseout amounts and the completed phaseout amounts shown in the table below.

ITEM	**ONE**	**TWO**	**THREE OR MORE**	**NONE**
Earned Income Amount	$9,920	$13,930	$13,930	$6,610
Maximum Amount of Credit	**$3,373**	**$5,572**	**$6,269**	**$506**
Threshold Phaseout Amount (Single, Surviving Spouse, or Head of Household)	$18,190	$18,190	$18,190	$ 8,270
Completed Phaseout Amount (Single, Surviving Spouse, or Head of Household)	$39,296	$44,648	$47,955	$14,880
Threshold Phaseout Amount (Married Filing Jointly)	$23,740	$23,740	$23,740	$13,820
Completed Phaseout Amount (Married Filing Jointly)	$44,846	$50,198	$53,505	$20,430

D. Definitions.

1. Earned Income. Only compensation included in gross income and net self-employment income is considered for EIC beginning in tax year 2002.

a. Wages, salaries, tips, and other employee compensation.

(1) Other employee compensation includes earnings from self-employment. I.R.C. § 32(c)(2).

(2) The IRS has concluded that if an individual, in order to claim EIC, reports net earnings from self-employment without claiming business expenses, the net earnings must be adjusted by those business expenses. The IRS further concluded that an individual's EIC and self-employment tax liability are both computed on adjusted net earnings from self-employment. If the individual cannot show that the business exists, he or she cannot claim the EIC based on net earnings from self-employment and is not liable for self-employment tax. I.R.S. Legal Memorandum, 2000-22-051 (April 6, 2000), available at Tax Notes Today, 2000 TNT 108-64 (June 5, 2000).

b. Military taxpayers **NO LONGER** include:

(1) Housing and subsistence allowances and in-kind equivalents received by Servicemembers

(2) Combat zone excluded pay. A **taxpayer may elect to treat pay that is otherwise excluded from gross income under IRC § 112 (combat zone tax exclusion) as earned income for purposes of the earned income credit. If the taxpayer makes this election, enter the amount of combat zone excluded income on Line 64(b) of Form 1040. (DFAS will include the combat zone excluded income in Box 12 of the W-2 with code Q).**

2. Earned income does not include Temporary Assistance for Needy Families (TANF) (formerly known as AFDC), interest, dividends, social security payments, pensions or annuities, Veteran's benefits, and variable housing allowances.

a. In a service center advice, the IRS has concluded that jury fees are not earned income for purposes of the EIC. IRS Service Center Advice, 2000-28-035 (June 14, 2000),

available at Tax Notes Today, 2000 TNT 137-52 (July 17, 2000).

(1) For jury fees to be earned income for the EIC, the payments must either be an employee's wages, salary, tips, or other compensation, or be a self-employed individual's net earnings from self-employment.

(2) The IRS determined that jurors are not employees and, thus, amounts paid to them for services performed are not wages, salaries, tips, or other employee compensation. The IRS also concluded that amounts paid to jurors are not net earnings from self-employment. Jury fees, the IRS reasoned, are for the performance of a civic duty analogous to public office, and I.R.C. § 1402(c)(1) excludes the performance of functions of a public office from the term "trade or business" for purposes of the net earnings from self-employment.

b. Foster care payments that are excluded from income under I.R.C. § 131 are not earned income for purposes of the EIC. I.R.S. Legal Memorandum, 1999-34-018 (August 27, 1999), available at Tax Notes Today, 1999 TNT 167-30 (August 20, 1999).

c. The Tax Court and the U.S. Court of Appeals for the Sixth Circuit disallowed an individual's claimed EIC for lack of evidence of any earned income. Powers v. Commissioner, 86 AFTR2d Par. 2000-5498, available at Tax Notes Today, 2000 TNT 217-6 (November 8, 2000); T.C. Memo 2000-5; 2000 Tax Ct. Memo LEXIS 4; 79 T.C.M. (CCH) 1287.

(1) Taxpayer filed 1996 federal income tax return in 1997 as head of household, two dependency exemptions, and reported wage income of $11,212 from AFDC, social security disability benefits, supplemental security income, and gifts. The taxpayer reported no other income and an EIC of $3,556.

(2) The taxpayer was not entitled to the EIC because she had no earned income in that year. The taxpayer asserted she worked regularly for friends and relatives, but did not down the work involved any employment related activity. The taxpayer did not present any evidence that she had earned income and was ineligible for the EIC.

3. Qualifying child. I.R.C. § 32(c)(3).

a. Three Part Test: Relationship, Age, Residency

b. **Relationship**: Taxpayer's son, daughter, adopted child, grandchild, stepchild, eligible foster child, or a descendant of any of them; or taxpayer's brother, sister, half-sister, half-brother, stepbrother, stepsister, or a descendant of any of them.

(1) Eligible foster child for purposes of qualifying child for the EIC is a child placed with the taxpayer by an authorized placement agency and who is cared for as the taxpayer's own child.

(2) An adopted child includes a child lawfully placed with you for a legal adoption.

c. **Age**:

(1) The child must be under the age of 19 at the end of the tax year or under 24 and a full time student,

(2) Any age if permanently and totally disabled, and

(3) Younger than the person claiming the child.

d. **Residency**: The qualifying child must have lived in the taxpayer's main home for more than 6 months of the year.

(1) Taxpayer may still satisfy this requirement if away from home on a temporary absence due to special circumstance.

(2) Temporary absence examples:

(a) illness,

(b) attending school,

(c) business,

(d) military service.

(3) For purposes of determining whether a qualifying child meets the residence test, the principal place of abode shall be treated as in the United States for any period during which a member of the Armed Forces is stationed outside the United States while serving on active duty.

(4) The IRS has ruled that Servicemembers who reside in Puerto Rico when on extended active duty may qualify for the EIC. If the other requirements of I.R.C. § 32 are met, the individual will qualify for the EIC. The IRS further determined that Puerto Rico Servicemembers who are stationed in the U.S. are within the U.S. for purposes of the EIC. Consequently, if a Puerto Rican Servicemember is stationed in the U.S. that individual may qualify for the EIC if the individual maintains a principal place of abode in the U.S. for more than half of the tax year, but still may be liable for tax to Puerto Rico. I.R.S. Technical Memorandum, 2000-25-055 (May 1, 2000), available at Tax Notes Today, 2000 TNT 123-84 (June 26, 2000).

e. The qualifying child cannot have filed a joint return other than to claim a refund.

E. Computing the EIC.

1. The credit is determined by multiplying an individual's earned income that does not exceed a maximum amount (called earned income amount) by the applicable credit percentage. The credit is reduced by a limitation amount determined by multiplying the applicable phaseout percentage by the excess of the amount of the individuals AGI (or earned income, if greater) over the phaseout amount.

F. Claiming the EIC:

1. Use the Schedule EIC to see if eligible for the credit. The credit amounts are determined by completing the worksheets in the 1040 or 1040A instruction booklets and then consulting the EIC tables.

2. Enter the amount from Worksheet A on Form 1040.

G. No credit is allowed if the taxpayer has excess disqualified income over $3,400 for the tax year 2016. I.R.C. § 32(i)(1). Disqualified income means:

1. Interest or dividends to the extent includable in gross income. I.R.C. § 32(i)(2)(A);

2. Tax exempt interest. I.R.C. § 32(i)(2)(B);

3. The excess of gross income from nonbusiness rents or royalties over the sum of the noninterest deductions that are clearly and directly allocable to that gross income and the interest deductions properly allocable to the gross income. I.R.C. § 32(i)(2)(C);

4. The taxpayer's capital gain net income for the year. I.R.C. § 32(i)(2)(D);

5. The excess of the aggregate income from all passive activities for the year over the aggregate losses from all passive activities for the tax year. I.R.C. § 32(i)(2)(E).

6. A child's interest, dividends, and capital gain distributions are considered to be the parent's interest, dividends, and capital gain distributions for earned income credit purposes if the parent elects to include them on his federal tax return. A child's income retains its character on a parent's return. I.R.S. Legal Memorandum, 1999-51-034, available at Tax Notes Today, 1999 TNT 247-63 (December 27, 1999).

H. No credit is allowed for 10 years after a year in which the EIC was claimed fraudulently (two years for erroneously claimed credit due to reckless or intentional disregard of the rules). If the EIC is denied under deficiency procedures, no credit is allowed for any later tax year unless the taxpayer provides information the IRS requires demonstrating eligibility. I.R.C. § 32(k).

XIV. CONCLUSION.

CHAPTER L

SALE OF RENTAL PROPERTY

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SALE OF RENTAL PROPERTY

OUTLINE OF INSTRUCTION

I. REFERENCES:

A. Internal Revenue Code of 1986.

B. Treasury Regulations.

C. IRS Publications.

1. Pub. 523, Selling Your Home.
2. Pub. 527, Residential Rental Property.
3. Pub. 530, Tax Information for First-Time Homeowners.
4. Pub. 534, Depreciating Property Placed in Service Before 1987.
5. Pub. 537, Installment Sales.
6. Pub. 544, Sales and Other Dispositions of Assets.
7. Pub. 551, Basis of Assets.
8. Pub 946, How to Depreciate Property.

II. INTRODUCTION.

Determining the gain and tax due arising from the sale of rental property is complex. The complexity arises from the "business use" of such property, the ability to depreciate this property, the requirement to adjust the basis of the property for such allowable depreciation, and the requirement to recapture gain attributable to depreciation.

III. GAIN, LOSS, AND OTHER USEFUL DEFINITIONS.

A. Gain: The amount realized from the sale or exchange of property that is more than the adjusted basis.

B. Loss: The adjusted basis of the property that is more than the amount realized.

C. Basis: The amount from which gain or loss is determined. The original basis of a home is its cost (purchase price) including any debt assumed or incurred. (I.R.C. § 1012). If the home was constructed, its original basis is the cost of land plus the amount to construct the residential building. A basis other than cost must be used if the property was acquired by inheritance, gift or received from spouse incident to divorce.

D. Adjusted Basis: The adjusted basis of property is the original cost or other basis plus certain additions and minus certain deductions, such as depreciation and casualty losses. (I.R.C. § 1016)

E. Amount realized: The amount realized from a sale or exchange is the total of all money received plus the fair market value of all property or services received. The amount realized also includes any liabilities that were assumed by the buyer and any liabilities to which the property transferred is subject, such as real estate taxes or a mortgage.

F. Amount recognized: That portion of an amount realized, which bears some economic or tax consequence. Gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income. Recognized losses may be deductible from gross income.

G. Fair market value: The price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of the relevant facts.

IV. HOW TO FIGURE GAIN OR LOSS.

A. To figure the gain or loss on the sale of a main home, the taxpayer must know the selling price, the amount realized, and the adjusted basis.

1. Selling price.

a. The selling price is the total amount the taxpayer receives for his home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

b. The selling price of the home does not include amounts received for personal property sold with the home. Personal property is property that is not a permanent part of the home. Examples are furniture, draperies, and lawn equipment. Separately stated cash received for these items should not be shown on Form 1099–S.

c. Payment by employer. The home may be sold because of a job transfer. If the employer pays for a loss on the sale or for selling expenses, do not include the payment as part of the selling price. The employer will include it in box 1 of the Form W–2 and the taxpayer will include it on line 7 of Form 1040.

2. Amount realized.

a. The amount realized is the selling price minus selling expenses.

b. Selling expenses include commissions, advertising fees, legal fees, and loan charges paid by the seller, such as loan placement fees or "points."

3. Adjusted basis. While the taxpayer owns the home, he may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

B. Amount of gain or loss.

1. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part that may be excluded, generally is taxable.

2. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of a main home cannot be deducted. (I.R.C. § 165, Treas. Reg. § 1.165-9).

3. Jointly owned home.

a. If the taxpayer and his spouse sell a jointly owned home and file a joint return, they figure the gain or loss as one taxpayer.

b. If the taxpayers file separate returns, each must figure their own gain or loss according to the individual ownership interest in the home. State law determines ownership interest.

c. If the taxpayer and a joint owner other than the spouse sell a jointly owned home, then each of must figure their own gain or loss according to the individual ownership interest in the home.

C. Basis.

1. Cost as Basis. (I.R.C. § 1012) The cost of property is the amount paid for it in cash, debt obligations, or other property.

a. Cost basis includes the purchase price and certain settlement or closing costs. The purchase price includes the down payment and any debt, such as a first or second mortgage or notes given the seller in payment for the home.

b. Settlement fees or closing costs.

(1) Include in basis the settlement fees and closing costs paid for buying the home. Do not include in basis the fees and costs for getting a mortgage loan. A fee for buying the home is any fee you would have had to pay even if you paid cash for the home.

(2) Settlement fees do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

(3) Settlement fees or closing costs that can be included in the basis of the property are:

(a) Abstract fees (abstract of title fees),

(b) Charges for installing utility services,

(c) Legal fees (including fees for the title search and preparing the sales contract and deed),

(d) Recording fees,

(e) Survey fees,

(f) Transfer taxes,

(g) Owner's title insurance, and

(h) Any amounts the seller owes that the buyer agrees to pay, such as:

(i) Certain real estate taxes,

(ii) Back interest,

(iii) Recording or mortgage fees,

(iv) Charges for improvements or repairs, and

(v) Sales commissions.

(4) Settlement fees and closing costs not included in basis are:

(a) Fire insurance premiums,

(b) Rent for occupancy of the house before closing,

(c) Charges for utilities or other services related to occupancy of the house before closing,

(d) Any fee or cost that you deducted as a moving expense (allowed for certain fees and costs before 1994),

(e) Charges connected with getting a mortgage loan, such as:

(i) Mortgage insurance premiums (including VA funding fees),

(ii) Loan assumption fees,

(iii) Cost of a credit report, and

(iv) Fee for an appraisal required by a lender, and

(f) Fees for refinancing a mortgage.

c. Construction. If the taxpayer contracted to have the house built on land owned by the taxpayer, the basis is:

(1) The cost of the land, plus

(2) The amount it cost to complete the house, including:

(a) The cost of labor and materials,

(b) Any amounts paid to a contractor,

(c) Any architect's fees,

(d) Building permit charges,

(e) Utility meter and connection charges, and

(f) Legal fees directly connected with building the house.

(3) Cost includes down payment and any debt, such as a first or second mortgage or notes given the seller or builder. It also includes certain settlement or closing costs.

(4) Self built. If the taxpayer built all or part of the house himself, its basis is the total amount it cost to complete the home. Do not include in the cost of the house:

(a) The value of the taxpayers own labor, or

(b) The value of any other labor the taxpayer did not pay for.

2. Basis Other Than Cost. (Generally)

a. Home received as gift. (I.R.C. § 1015)

(1) The donee acquires the adjusted basis of the donor.

(2) Exception:

(a) If using the donor's adjusted basis results in a loss upon sale of the home, the donee must use the home's fair market value at time of transfer as the basis for the sale.

(b) If using the fair market value results in a gain (while using the donor's adjusted basis would have resulted in a loss), then the donee recognizes neither a gain nor a loss upon the sale.

b. Home received from spouse/incident to divorce. (I.R.C. § 1041)

(1) If received after July 18, 1984,

(a) No gain or loss on the transfer is recognized.

(b) Basis in this home is generally the same as spouse's (or former spouse's) adjusted basis just before the property is received. This rule applies even if received in exchange for cash, the release of marital rights, the assumption of liabilities, or other consideration.

(2) Transfers before July 19, 1984, in exchange for release of marital rights, basis in the home is generally its fair market value at the time it is received.

c. Home received as inheritance. (I.R.C. § 1014)

(1) Generally,

(a) The basis is its fair market value on the date of the decedent's death, or

(b) The later alternate valuation date if that date was used for federal estate tax purposes.

(c) If an estate tax return was filed, the value listed there for the property generally is your basis.

(d) If a federal estate tax return did not have to be filed, the donee's basis in the home is the same as its appraised value at the date of death for purposes of state inheritance or transmission taxes.

(2) Surviving spouse. (I.R.C. §§ 1015, 2040)

(a) A surviving spouse, who owned the home jointly with the decedent spouse, acquires a basis equal to:

(i) Basis for the half interest that the decent spouse owned will be one-half of the fair market value on the date of death (or alternate valuation date),

(ii) The basis in the surviving spouse's half will remain one-half of the adjusted basis determined previously.

Example. The jointly owned home had an adjusted basis of $50,000 on the date of the first spouse's death, and the fair market value on that date was $100,000. The surviving spouse's new basis in the home is $75,000 ($25,000 for one-half of the adjusted basis plus $50,000 for one-half of the fair market value).

d. Community property. (I.R.C. § 1015)

(1) In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), each spouse is usually considered to own half of the community property.

(2) When either spouse dies, the fair market value of the community property generally becomes the basis of the entire property, including the part belonging to the surviving spouse.

(3) For this to apply, at least half the value of the community property interest must be includible in the decedent's gross estate, whether or not the estate must file a return.

D. Adjusted Basis (I.R.C. § 1016)

1. Adjusted basis is the original basis increased or decreased by certain amounts.

a. Increases to basis, include any:

(1) Improvements that have a useful life of more than 1 year,

(2) Additions,

(3) Special assessments for local improvements, and

(4) Amounts spent after a casualty to restore damaged property.

b. Decreases to basis, include any:

(1) Gain postponed from the sale of a previous home before May 7, 1997,

(2) Deductible casualty losses,

(3) Insurance payments you received or expect to receive for casualty losses,

(4) Payments you received for granting an easement or right-of-way,

(5) Depreciation allowed or allowable if the home is used for business or rental purposes,

(6) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of the home,

(7) Adoption credit claimed for improvements added to the basis of the home,

(8) Nontaxable payments from an adoption assistance program of the employer used for improvements added to the basis of the home,

(9) First-time homebuyers credit (allowed to certain first-time buyers of a home in the District of Columbia), and

(10) Energy conservation subsidy excluded from the taxpayer's gross income because he received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

E. Disposition of partial interest – special rule. (I.R.C. § 1001(e))

1. A life tenant, a tenant for a term of years, or an income beneficiary of a trust is generally entitled to capital gain on sale of that interest.

2. However, where the interest was acquired by gift, from a decedent, by a transfer in trust or by a transfer from a spouse (or a former spouse incident to divorce), that part of the basis that's determined under the Code rules for those types of acquisitions (e.g., fair market value basis where acquired from a decedent dying before 2010) isn't taken into account in computing gain or loss on the sale or exchange of the interest, unless the entire interest in the underlying property is transferred in the same transaction. (I.R.C. § 1001(e); Treas. Reg.

Example 1. Your father dies and leaves his farm to you for life with a remainder interest to your younger brother. You decide to sell your life interest in the farm. The entire amount you receive is a recognized gain. Your basis in the farm is disregarded.

Example 2. The facts are the same as in Example 1, except that your brother joins you in selling the farm. The entire interest in the property is sold, so your basis in the farm is not disregarded. Your gain or loss is the difference between your share of the sales price and your adjusted basis in the farm.

V. HOMES QUALIFYING FOR EXCLUSION UNDER I.R.C. §121.

A. The taxpayer may be able to exclude any gain from income up to a limit of $250,000 ($500,000 on a joint return in most cases).

1. If all of the gain can be excluded, the taxpayer need not report the sale on the tax return.

2. If there is gain that cannot be excluded, it is taxable. Report it on Form 8949 and Schedule D (Form 1040).

B. Maximum Amount of Exclusion. The taxpayer may be able to exclude the entire gain on the sale of his main home up to:

1. $250,000, or

2. $500,000 if all of the following are true.

a. He is married and files a joint return for the year.

b. Either the taxpayer or his spouse meets the ownership test.

c. Both the taxpayer and his spouse meet the use test.

d. During the 2-year period ending on the date of the sale, neither the taxpayer nor his spouse excluded gain from the sale of another home.

e. The gain is not allocable to a period of "nonqualified use." (I.R.C. §121(b)(4)(C)). Gain allocable to periods of nonqualified use will be taxable and treated as capital gain

C. Reduced Maximum Exclusion**.**

1. The taxpayer can claim an exclusion, but the maximum amount of gain you can exclude will be reduced, if either of the following is true.

a. The taxpayer did not meet the ownership and use tests for a home sold due to:

(1) A change in health,

(2) A change in place of employment, or

(3) Unforeseen circumstances, to the extent provided in regulations.

b. The exclusion would have been disallowed because of use of the exclusion during the preceding 2-year period, except that the taxpayer sold the home due to:

(1) A change in health,

(2) A change in place of employment, or

(3) Unforeseen circumstances, to the extent provided in regulations.

D. Nonqualified Use. The period of time during which the property was not used as a principal residence.

1. Occurs after December 31, 2008.

2. Does not include the portion of the five-year period ending on the date of sale <u>after</u> the date the property is <u>last</u> used as the principal residence.

3. Does not include any period (up to 10 years) during which the military member is serving on qualified official extended duty (active duty) at least 50 miles from the property pursuant to military orders.

4. Does not include any other period of temporary absence (up to 2 years) due to change of employment, health, or other unforeseen circumstances.

Example: John and Mary purchased their principal residence for $350,000 in January 2006 and lived there until January 2008, when they converted it to a rental property. In January 2010, they moved back into the home and made it their principal residence. In January 2011, they sold the home for $600,000.

John and Mary are eligible to exclude gain, because they owned and used the property as their principal residence for two of the five years preceding its sale (Jan 2007 – Jan 2008 and Jan 2010 – Jan 2011). One year (Jan 2009 – Jan 2010) out of the five years they owned the property is considered nonqualified use. Of their total gain ($250,000), 1/5 may <u>not</u> be excluded ($50,000).

E. Special Situation. Exclusion not allowed in certain cases involving a like-kind exchange (I.R.C. § 1031). The exclusion is not allowed if:

1. The taxpayer acquired the home in a like-kind exchange, <u>and</u>

2. The home was sold

a. After October 22, 2004, <u>and</u>

b. During the 5-year period beginning with the date the taxpayer acquired the home.

F. Availability of homesale exclusion, where part of home was used for business or rental purposes.

1. Some taxpayers use part of their homes for business or rental purposes. For example, a professional such as an attorney, accountant, or doctor may use part of his home for business purposes, or the owner of a multi-story home may rent out a floor and use the balance of the property as his residence. If the entire property is used as a principal residence for at least two of the five years preceding the sale, and the other I.R.C. § 121 conditions are met, the homesale exclusion applies to all of the gain except that part of the gain attributable to post-May 6, '97 depreciation. (I.R.C § 121(d)(6)).

Example 1: Dr. Denton is a dentist with a downtown practice. Twenty years ago, he built a wing on to his house and configured the space as an office where he treated patients in the evenings and on weekends. In '96, he discontinued using the wing as an office and since that time he and his wife have used the entire property as their principal residence. In 2014, he sells the home for $700,000. His $300,000 basis in the home reflects $30,000 in depreciation claimed while he used part of his home as an office. All of Dr. Denton's $400,000 gain, on the sale of the home, including the gain representing depreciation claimed during ownership, is excludable under I.R.C § 121.

Example 2: The facts are the same as in example 1, except that Dr. Denton discontinued using part of the home as an office in Jan. of 2000, and claimed $3,000 in post-May 6, '97 depreciation. Here, $397,000 of the gain would be excluded, and the $3,000 balance would be taxed at rates up to 25% as unrecaptured I.R.C § 1250 gain.

2. If a home that was mixed-use (residence and nonresidence) property is not used entirely as a principal residence for at least two of the five years ending on the sale date, then the issue of how much of the gain may be excluded under I.R.C § 121 turns on where the non-residence use of the property took place:

   a. If the non-residence use of the property took place <u>within the dwelling unit</u>, all of the gain (except for the gain representing post-May 6, '97 depreciation) is eligible for the homesale exclusion.

   b. If the non-residence use of the property took place <u>outside of the dwelling unit</u>, then only the gain attributable to the dwelling-unit portion is eligible for the homesale exclusion (Treas. Reg. § 1.121-1 (e)(1)).

3. Availability of homesale exclusion where non-residence use of home occurred in the dwelling unit.

   a. If a home that was mixed-use (residence and non-residence) property is not used entirely as a principal residence for at least two of the five years ending on the sale date, the entire property nonetheless is treated as a residence for I.R.C § 121 purposes if both the residential and nonresidential use was within the same dwelling unit. (Treas. Reg. § 1.121-1(e)(1)).

b. That means none of the gain on the sale of the home is allocated to the non-residence use and all of the gain is eligible for the exclusion (if the taxpayer otherwise meets the requirements), except for depreciation attributable to post-May 6, '97, periods. (Treas. Reg. § 1.121-1(d)).

c. For purposes of the homesale exclusion rules, a dwelling unit means a house, apartment, condominium, mobile home, boat or similar property, but does not include appurtenant structures (e.g., a detached garage, guesthouse, or barn). (Treas. Reg. § 1.121-1(e)(2)).

d. If depreciation deductions were allowed or allowable because the home was used for business purposes or as rental property, the taxpayer cannot exclude the part of gain equal to any depreciation allowed or allowable as a deduction for periods after May 6, 1997.

Example: Dianne Davis, an attorney, buys a house in 2011. The house constitutes a single dwelling unit but Davis uses part of it (e.g., one of the bedrooms or a den) as a law office. Davis claims depreciation deductions of $2,000 during the period that she owns the house. She sells the house in 2014, realizing a gain of $13,000. She has no other I.R.C § 1231 or capital gains or losses for 2006. Davis must recognize $2,000 of the gain as unrecaptured I.R.C § 1250 gain taxed at rates up to 25%. She may exclude the remaining $11,000 of gain from the sale of her house because she doesn't have to allocate gain to the business use within the dwelling unit. (Treas. Reg. § 1.121-1(e)(4), Ex. 5)

e. Under I.R.C § 280A(c)(1), depreciation deductions for business use of a dwelling unit are available only if part of the dwelling unit is used regularly and exclusively as the principal place of a taxpayer's trade or business, or as a place to meet or deal with clients or customers in the ordinary course of the taxpayer's business. If a taxpayer's business use of a dwelling unit doesn't satisfy these conditions (e.g., a room is used during the day for business and as a family den in the evenings), depreciation deductions can't be claimed and all of the gain from its sale may be eligible for the homesale exclusion.

Example: The facts are the same as in the immediately previous example, except that Davis is not entitled to claim any depreciation deductions for her business use of the house. Davis may exclude the entire $13,000 of gain from the sale of her house. (Treas. Reg. § 1.121-1(e)(4), Ex. 6)

4. Homesale gain allocated where nonresidence use of home occurred outside of the dwelling unit. Gain on the sale of a mixed-use home must be allocated between the principal-residence portion and the non-principal-residence portion if:

   a. The entire home was not used entirely as a principal residence for at least two of the five years ending on the sale date, and

   b. The nonresidence (i.e., business or rental) use of the property occurred outside the dwelling unit

   c. Only the gain attributable to the principal-residence-portion of the property (the portion used as a principal residence for at least two of the five years ending with the sale date) may be excluded under I.R.C § 121. (Treas. Reg. § 1.121-1(e)(1)).

Example: In 2016, Arturo Acela sells a property that consists of a house, a stable and 35 acres. He used the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. Acela uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, '97, Acela claims depreciation deductions of $9,000 for the non-residential use of the stable. He realizes a gain of $24,000 on the sale of the property and has no other I.R.C § 1231 or capital gains or losses for 2016. Acela must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. He determines that $14,000 of the gain is allocable to the non-residential- use portion of the property and that $10,000 of the gain is allocable to the residence portion of the property. Acela must recognize $14,000 of gain ($9,000 of which is unrecaptured I.R.C § 1250 gain taxed at 25%, and $5,000 of which is adjusted net capital gain, which is taxed at 20% if Acela's other taxable income is taxed at a 25% or higher rate). Acela may exclude $10,000 of the gain from the sale of the property. (Treas. Reg. § 1.121-1(e)(4), Ex. 1)

5. Depreciation deductions claimed on the nondwelling-unit portion of the property are not taken into account when applying the rule that denies the I.R.C. § 121 exclusion for post-May 6, '97 depreciation. (Treas. Reg. § 1.121-1(d)(1)).

Example: In '98 Chet Baker buys a property that includes a house; a barn, and 2 acres. Baker uses the house and 2 acres as his principal residence and uses the barn for an antiques business. In 2002, he moves out of the house and rents it to tenants. Baker sells the property in 2004, realizing a gain of $21,000. Between '98 and 2004, he claims $4,800 of depreciation deductions attributable to the antiques business. Between 2002 and 2004 he claims $3,000 of depreciation deductions attributable to the house. Baker has no other I.R.C § 1231 or capital gains or losses for 2004.

Because the portion of the property used in the antiques business was separate from the dwelling unit, Baker must allocate basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. He determines that $4,000 of the gain is allocable to the non-residential portion of the property and that $17,000 of the gain is allocable to the principal-residence portion of the property.

Baker must recognize the $4,000 of gain allocable to the non-residential portion of the property (all of which is unrecaptured I.R.C § 1250 gain taxed at a maximum rate of 25%). The homesale exclusion doesn't apply to the extent of the $3,000 in depreciation claimed on the residential portion of the property for periods after May 6, '97, but the exclusion isn't affected by the depreciation claimed on the antiques business. As a result, Baker may exclude $14,000 of the gain from the sale of the property. (Treas. Reg. § 1.121-1(e)(4), Ex. 2)

6. How gain is allocated.

a. To determine the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate basis and amount realized between the residential and the non-residential portions using the same method of allocation he used to determine depreciation adjustments. (Treas. Reg. § 1.121-1(e)(3)). In other words, the gain allocation is based not on relative values at the time of sale but on relative values when the taxpayer <u>began</u> depreciating the non-residential portion of the property

b. To determine the depreciable portion of a property used partially for business or rental purposes from the time it was purchased, a taxpayer must first allocate the purchase price between the improvements and the land. This allocation generally is based on the ratio of the depreciable improvements' value at acquisition to the entire property's value at that time. (Treas. Reg. § 1.167(a)-5; Treas. Reg. § 1. 167(a)-5T) The taxpayer also would have to allocate the overall value of the improvements between the residential and nonresidential portions.

c. When a property used entirely as a residence is converted to business or rental use, then for purposes of calculating losses or depreciation (but not for purposes of calculating gain) the basis for the property on the date of its conversion is the lower of its adjusted basis or fair market value on that date. (Treas. Reg. § 1.167(g)(1). This rule would also apply to the nonresidence portion of a home that is converted to partial business or rental use.

G. Reporting the Gain

1. Do not report the sale of a main home on the taxpayer's tax return unless:

a. He has a gain and does not qualify to exclude all of it, or

b. He has a gain and chooses not to exclude it.

2. If there is any taxable gain on the sale of the main home that cannot be excluded, report the entire gain realized on Form 8949 and Schedule D (Form 1040).

a. If the taxable gain is short term

(1) On Form 8949, immediately above line 1, check Block C.

(2) Report the sale on line 1. Enter "H" in column (b).

(3) Report the gross sales price (not reduced for expenses of sale) in column (e).

(4) Enter the amount of gain to be excluded PLUS the expenses of sale in parenthesis in column (g).

(5) Then, report the totals from line 2 to Schedule D (Form 1040), line 3.

b. If the taxable gain is long term

(1) On Form 8949, immediately above line 3, check Block C.

(2) Report the sale on line 3. Enter "H" in column (b).

(3) Report the gross sales price (not reduced for expenses of sale) in column (e).

(4) Enter the amount of gain to be excluded PLUS the expenses of sale in parenthesis in column (g).

(5) Then, report the totals from line 4 to Schedule D (Form 1040), line 10.

3. Report the taxable gain on the non-residential business portion of the home on Form 4797.

VI. EXAMPLES – HOMES QUALIFYING UNDER I.R.C. § 121.

A. Qualifying under I.R.C. § 121. Owned and occupied at time of sale after a period of rental. No business or rental use in the year of sale. Reporting nonqualified use and post-May 6, 1997 depreciation. A comprehensive example follows.

- Illustrated Example -

Emily White, a single person, bought a home on May 1, 2001. She lived in the home until May 31, 2011, when she moved out and put it up for rent. Emily rented her home from June 1, 2011, until May 31, 2012. She moved back into the house and lived there until she sold it on January 11, 2013.

Emily can exclude gain on the sale of her home because she owned and lived in the home for at least 2 years of the 5-year period ending on the date of the sale.
Emily's records show the following:

1) Original cost	$ 50,000
2) Legal fees for title search	750
3) Back taxes paid for prior owner	1,500
4) Improvements (deck)	2,000
5) Selling price	195,000
6) Commission and expenses of sale	15,000
7) Depreciation claimed after May 6, 1997	1,791

Emily uses Worksheet 1 [Pub 523] to figure the adjusted basis of the home she sold ($52,459). She uses Worksheet 2 [Pub 523] to figure the gain on the sale ($127,541), the amount of her taxable gain ($12,480) and the amount of her exclusion ($115,061).

Emily cannot exclude $12,480. This includes $1,791, the part of her gain equal to the depreciation deduction claimed while the house was rented, plus $10,689, the amount of her gain from nonqualified use.

Emily reports the sale in Part II of Form 8949 and Part II of Schedule D (Form 1040). On her Form 8949, Part II, she reports her selling price of $195,000 in column (e) and her adjusted basis of $52,459 in column (f). In column (g), she reports the sum of her exclusion and her selling expenses as a negative number. She enters “H” and “O” in column (b). She enters $1,791 on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the Schedule D (Form 1040) instructions. She has no gains or losses from the sale of property other than the gain from the sale of her home. Therefore, she also enters $1,791 on lines 13 and 18 of the worksheet and on line 19 of Schedule D. She then figures her tax using the Schedule D Tax Worksheet in the Schedule D (Form 1040) instructions

Emily's completed *Worksheets* 1 & 2, her Schedule D, and her *Unrecaptured Section 1250 Gain Worksheet* follow.

Worksheet 1. Adjusted Basis of Home Sold—Illustrated Example 3 for Emily White

Keep for Your Records

Caution: *See the Worksheet 1 Instructions before you use this worksheet.*

1.	Enter the purchase price of the home sold. (If you filed Form 2119 when you originally acquired that home to postpone gain on the sale of a previous home before May 7, 1997, enter the adjusted basis of the new home from that Form 2119.)			1.	$50,000
2.	Seller-paid points for home bought after 1990 (see *Seller-paid points*). Do not include any seller-paid points you already subtracted to arrive at the amount entered on line 1			2.	
3.	Subtract line 2 from line 1			3.	50,000
4.	Settlement fees or closing costs (see *Settlement fees or closing costs*). If line 1 includes the adjusted basis of the new home from Form 2119, skip lines 4a–4g and 5; go to line 6				
a.	Abstract and recording fees	4a.			
b.	Legal fees (including fees for title search and preparing documents)	4b.	750		
c.	Survey fees	4c.			
d.	Title insurance	4d.			
e.	Transfer or stamp taxes	4e.			
f.	Amounts that the seller owed that you agreed to pay (back taxes or interest, recording or mortgage fees, and sales commissions)	4f.	1,500		
g.	Other	4g.			
5.	Add lines 4a through 4g			5.	2,250
6.	Cost of additions and improvements. Do not include any additions and improvements included on line 1			6.	2,000
7.	Special tax assessments paid for local improvements, such as streets and sidewalks			7.	
8.	Other increases to basis			8.	
9.	Add lines 3, 5, 6, 7, and 8			9.	54,250
10.	Depreciation allowed or allowable, related to the business use or rental of the home	10.	1,791		
11.	Other decreases to basis (see *Decreases to Basis*)	11.			
12.	Add lines 10 and 11			12.	1,791
13.	**Adjusted basis of home sold.** Subtract line 12 from line 9. Enter here and on Worksheet 2, line 4			13.	$52,459

Worksheet 2. Taxable Gain on Sale of Home—Illustrated Example 3 for Emily White

Keep for Your Records

Part 1. Gain or (Loss) on Sale			
1.	Selling price of home	1.	$195,000
2.	Selling expenses (including commissions, advertising and legal fees, and seller-paid loan charges)	2.	15,000
3.	Subtract line 2 from line 1. This is the amount realized	3.	180,000
4.	Adjusted basis of home sold (from Worksheet 1, line 13)	4.	52,459
5.	**Gain or (loss)** on the sale. Subtract line 4 from line 3. If this is a loss, stop here	5.	127,541
Part 2. Exclusion and Taxable Gain			
6.	Enter any depreciation allowed or allowable on the property for periods after May 6, 1997. If none, enter -0-	6.	1,791
7.	Subtract line 6 from line 5. If the result is less than zero, enter -0-	7.	125,750
8.	Aggregate number of days of nonqualified use after 12/31/2008	8.	365
9.	Number of days taxpayer owned the property	9.	4,273
10.	Divide the amount on line 8 by the amount on line 9. Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.00	10.	.085
11.	Gain allocated to nonqualified use. (Line 7 multiplied by line 10)	11.	10,689
12.	Gain eligible for exclusion. Subtract line 11 from line 7.	12.	115,061
13.	If you qualify to exclude gain on the sale, enter your maximum exclusion (see *Maximum Exclusion*). If you qualify for a reduced maximum exclusion, enter the amount from Worksheet 3, line 7. If you do not qualify to exclude gain, enter -0-	13.	250,000
14.	**Exclusion.** Enter the smaller of line 12 or line 13	14.	115,061
15.	**Taxable gain.** Subtract line 14 from line 5. Report your taxable gain as described under *Reporting the Sale*. If the amount on this line is zero, do not report the sale or exclusion on your tax return. **If the amount on line 6 is more than zero, complete line 16**	15.	12,480
16.	Enter the **smaller** of line 6 or line 15. Enter this amount on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D (Form 1040)	16.	$1,791

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Information about Form 8949 and its separate instructions is at *www.irs.gov/form8949*.

▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074

2013

Attachment Sequence No. **12A**

Name(s) shown on return: Emily White

Social security number or taxpayer identification number: 022-00-2222

Most brokers issue their own substitute statement instead of using Form 1099-B. They also may provide basis information (usually your cost) to you on the statement even if it is not reported to the IRS. Before you check Box A, B, or C below, determine whether you received any statement(s) and, if so, the transactions for which basis was reported to the IRS. Brokers are required to report basis to the IRS for most stock you bought in 2011 or later.

Part I **Short-Term.** Transactions involving capital assets you held one year or less are short term. For long-term transactions, see page 2.

Note. You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 1a; you are not required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, or C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)

☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS

☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 1b** (if **Box A** above is checked), **line 2** (if **Box B** above is checked), or **line 3** (if **Box C** above is checked) ▶							

Note. If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37768Z Form **8949** (2013)

Name(s) shown on return. (Name and SSN or taxpayer identification no. not required if shown on other side.)	Social security number or taxpayer identification number
Emily White	022-00-2222

Most brokers issue their own substitute statement instead of using Form 1099-B. They also may provide basis information (usually your cost) to you on the statement even if it is not reported to the IRS. Before you check Box D, E, or F below, determine whether you received any statement(s) and, if so, the transactions for which basis was reported to the IRS. Brokers are required to report basis to the IRS for most stock you bought in 2011 or later.

Part II **Long-Term.** Transactions involving capital assets you held more than one year are long term. For short-term transactions, see page 1.

Note. You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 8a; you are not required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
- ☑ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see Column (e) in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
Main Home	05/01/2001	01/11/2013	195,000	52,459	H,O	(130,061)	12,480
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶			195,000	52,459		(130,061)	12,480

Note. If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Schedule D and its separate instructions is at www.irs.gov/scheduled.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2013

Attachment Sequence No. **12**

Name(s) shown on return | Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7	

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

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked	195,000	52,459	(130,061)	12,480

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then go to Part III on the back	15	12,480

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Part III **Summary**

16	Combine lines 7 and 15 and enter the result	16	12,480
	• If line 16 is a **gain,** enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below. • If line 16 is a **loss,** skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. • If line 16 is **zero,** skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.		
17	Are lines 15 and 16 **both** gains? ☐ **Yes.** Go to line 18. ☐ **No.** Skip lines 18 through 21, and go to line 22.		
18	Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** in the instructions ▶	18	
19	Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** in the instructions ▶	19	1,791
20	Are lines 18 and 19 **both** zero or blank? ☐ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). **Do not** complete lines 21 and 22 below. ☐ **No.** Complete the **Schedule D Tax Worksheet** in the instructions. **Do not** complete lines 21 and 22 below.		
21	If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of: • The loss on line 16 or • ($3,000), or if married filing separately, ($1,500)	21	( )
	Note. When figuring which amount is smaller, treat both amounts as positive numbers.		
22	Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b? ☐ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). ☐ **No.** Complete the rest of Form 1040 or Form 1040NR.		

Unrecaptured Section 1250 Gain Worksheet—Line 19

Keep for Your Records

If you are not reporting a gain on Form 4797, line 7, skip lines 1 through 9 and go to line 10.

1.	If you have a section 1250 property in Part III of Form 4797 for which you made an entry in Part I of Form 4797 (but not on Form 6252), enter the **smaller** of line 22 or line 24 of Form 4797 for that property. If you did not have any such property, go to line 4. If you had more than one such property, see instructions		**1.**	
2.	Enter the amount from Form 4797, line 26g, for the property for which you made an entry on line 1		**2.**	
3.	Subtract line 2 from line 1		**3.**	
4.	Enter the total unrecaptured section 1250 gain included on line 26 or line 37 of Form(s) 6252 from installment sales of trade or business property held more than 1 year (see instructions)		**4.**	
5.	Enter the total of any amounts reported to you on a Schedule K-1 from a partnership or an S corporation as "unrecaptured section 1250 gain"		**5.**	
6.	Add lines 3 through 5		**6.**	
7.	Enter the **smaller** of line 6 or the gain from Form 4797, line 7	**7.**		
8.	Enter the amount, if any, from Form 4797, line 8	**8.**		
9.	Subtract line 8 from line 7. If zero or less, enter -0-		**9.**	
10.	Enter the amount of any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain (see instructions)		**10.**	
11.	Enter the total of any amounts reported to you as "unrecaptured section 1250 gain" on a Schedule K-1, Form 1099-DIV, or Form 2439 from an estate, trust, real estate investment trust, or mutual fund (or other regulated investment company) or in connection with a Form 1099-R		**11.**	
12.	Enter the total of any unrecaptured section 1250 gain from sales (including installment sales) or other dispositions of section 1250 property held more than 1 year for which you did not make an entry in Part I of Form 4797 for the year of sale (see instructions)		**12.**	1,791
13.	Add lines 9 through 12		**13.**	1,791
14.	If you had any section 1202 gain or collectibles gain or (loss), enter the total of lines 1 through 4 of the **28% Rate Gain Worksheet**. Otherwise, enter -0-	**14.**		
15.	Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0-	**15.** ( )		
16.	Enter your long-term capital loss carryovers from Schedule D, line 14, and Schedule K-1 (Form 1041), box 11, code C*	**16.** ( )		
17.	Combine lines 14 through 16. If the result is a (loss), enter it as a positive amount. If the result is zero or a gain, enter -0-		**17.**	
18.	**Unrecaptured section 1250 gain.** Subtract line 17 from line 13. If zero or less, enter -0-. If more than zero, enter the result here and on Schedule D, line 19		**18.**	1,791

*If you are filing Form 2555 or 2555-EZ (relating to foreign earned income), see the footnote in the Foreign Earned Income Tax Worksheet in the Form 1040 instructions before completing this line.

B. Qualifying under I.R.C. § 121. Owned and occupied, but with partial business use at the time of sale. Reporting business gain/loss and post May 6, 1997 depreciation.

1. The Code Sec. 121 exclusion does *not* apply to the gain allocable to any portion (*separate from the dwelling unit*) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (*separate from the dwelling unit*) was used for non-residential purposes, only the gain allocable to the residential portion is excludable from gross income under I.R.C. § 121; Treas. Reg. §1.121-1(e)(1).

2. If the depreciation for periods after May 6, '97, attributable to the nonresidential portion of the property (see below) exceeds the gain allocable to the non-residential portion of the property, the excess does not reduce the I.R.C § 121 exclusion applicable to the gain allocable to the residential portion of the property. (Preamble to TD No. 9030, 12/23/2002).

3. If a taxpayer sells the entire property, he treats the transaction as the sale of two properties. The sale of the portion of the property used for business or rental is reported on Form 4797.

4. In order to determine the amounts to report on Form 4797, the taxpayer has to divide the selling price, selling expenses, and basis between the part of the property used for business or rental and the part used as a home. In the same way, if the taxpayer qualifies to exclude any gain on the business or rental part of the home, he divides his maximum exclusion between that part of the property and the part used as a home. (IRS Pub. 523, (2011), p. 17).

5. Allocation is no longer required when business use occurs <u>within</u> the dwelling unit.

6. However, allocation is required when business use occurs outside of the dwelling unit. The example that follows depicts the method of allocation appropriately. However, you should assume that the business use occurred <u>outside</u> of the dwelling unit.

- EXAMPLE -

In January 2002, you bought and moved into a 4-story townhouse. In December 2006, you converted the basement level, which has a separate entrance into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that led from the basement to the upper floors. After you completed the conversion, your townhouse had a rental unit that was separate from the part of your house used as your home. You lived in the first, second, and third levels of the townhouse and rented the basement level to tenants until December 2008. You claimed depreciation deductions of $2,000 for the basement apartment. You sold the entire townhouse in December 2008 for a $16,000 gain. Your records show the following:

Purchase price	$ 96,000
Depreciation (on business part)	2,000
Selling price	120,000
Selling expenses	10,000

Because you meet the ownership and use tests for the entire house, you can claim the exclusion for both the home and business parts. You start by finding the adjusted basis of each part. You determine that three-fourths (75%) of your purchase price was for the part used as your home; one-fourth (25%) was for the part used for business.

	Personal (3/4)	Business (1/4)
Purchase price	$72,000	$24,000
Minus: Depreciation	-0-	2,000
Adjusted basis	$72,000	$22,000

Next, you figure the gain on each part, dividing your selling price and selling expenses between the two parts.

	Personal (3/4)	Business (1/4)
Selling price	$90,000	$30,000
Minus: Selling expenses	7,500	2,500
	82,500	27,500
Minus: Adjusted basis	72,000	22,000
Gain	$10,500	$5,500

Then, to figure your taxable gain and exclusion on each part, you decide to fill out a separate Worksheet 2 (Part 2) [Pub 523] for each part, dividing your maximum exclusion between the two parts. You are single, so your maximum exclusion is $250,000.

	Personal (3/4)	Business (1/4)
Part 2-Exclusion and Taxable Gain		
6) Depreciation after May 6, 1997	$ -0-	$ 2,000
7) Subtract line 6 from gain	10,500	3,500
8) Maximum exclusion	$187,500	$62,500
9) Exclusion (Smaller of line 7 or line 8)	10,500	3,500
10) Taxable gain (gain minus line 9)	-0-	*
11) Smaller of line 6 or line 10	-0-	*

NOTE: * Lines 10 and 11 do not need to be filled out for the business part.

The gain from the part used as your home does not have to be reported on your return, because you can exclude all of it. You report the gain from the business part ($5,500) in Part III of Form 4797. You enter your exclusion ($3,500) on line 2 of Form 4797. Your taxable gain from the business part is $2,000 ($5,500 − $3,500).

C. Qualifying under I.R.C. § 121. Owned and vacated, held out as a rental at time of sale. Reporting business gain/loss and post May 6, 1997 depreciation.

1. Fact pattern:

Example:

Own & occupy – Vacate & Rent – Sell

Example. On May 30, 2006, CPT Amy Smith bought a house. She moved in on that date and lived in it until May 31, 2008, when she moved out of the house pursuant to PCS orders and put it up for rent. The house was rented from June 1, 2008, until she sold it on January 31, 2012. During the 5-year period ending on the date of the sale (February 1, 2007 – January 31, 2012), CPT Amy owned the house for 5 years, but only lived in it for 16 months. CPT Amy's move was due to a change in place of employment and qualifies for the reduced exclusion under I.R.C. § 121(c)(2)(B)).

Five Year Period	Used as Home	Used as Rental
2/1/07 - 5/31/08	16 months	
6/1/08 - 1/31/12		44 months
	16 months	44 months

Amy can exclude gain up to $166,667 of gain. However, she cannot exclude the part of the gain equal to the depreciation she claimed for renting the house after May 6, 1997.

2. If the taxpayer used the home to produce rental income during the year of sale, the taxpayer must use Form 4797, Sale of Business Property, to report the sale of the business of rental part of the (or the sale of the entire property if used entirely for business or rental in the year of sale). (IRS Pub. 523, Selling Your Home).

a. If the property was used for business or to produce rental income and was also owned and used as the taxpayer's home during the 5-year period ending on the date of sale, the taxpayer may be able to exclude part of all of the gain figured on Form 4797.

b. Property held more than one year.

(1) Complete Part III of Form 4797 to determine the gain.

(2) Do not take the exclusion arising from I.R.C. § 121 into account when determining the gain on line 24 of Form 4797.

(3) If the depreciation entered on line 22 of Form 4797 includes depreciation taken for periods after May 6, 1997, the taxpayer cannot exclude gain to the extent of such depreciation.

(4) On line 2 of Form 4797, write "Section 121 Exclusion," and enter the amount of the exclusion as a loss in column (g).

c. Property held less than one year. Report the sale and amount of the exclusion, if any, in a similar manner on line 10 of Form 4797.

d. For example, see previous example. Report in a similar fashion using Form 4797, Form 8949, and Form 1040-Schedule D.

VII. PROPERTY NOT QUALIFYING FOR EXCLUSION UNDER I.R.C. § 121.

A. Introduction: Sale of rental property, which does not qualify for capital gain exclusion under I.R.C. § 121, is generally treated as the sale of business property. The gain from the sale of business property is taxable to the seller as income.

B. Ordinary or Capital Gain or Loss for Business Property

1. When the taxpayer disposes of business property, the taxable gain or loss is usually a section 1231 gain or loss. Its treatment as ordinary or capital is determined under rules for section 1231 transactions.

2. When the taxpayer disposes of depreciable property (section 1245 property or section 1250 property) at a gain, he may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules.

C. Section 1231 Gains and Losses

1. Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions. Their treatment as ordinary or capital depends on whether you have a net gain or a net loss from all your section 1231 transactions.

2. **Caution.** If there is a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules (explained later). Do not take that gain into account as section 1231 gain.

3. Section 1231 transactions: The following transactions result in gain or loss subject to section 1231 treatment.

a. Sales or exchanges of real property or depreciable personal property. This property must be used in a trade or business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business.

b. Sales or exchanges of leaseholds. The leasehold must be used in a trade or business and held longer than 1 year.

c. Sales or exchanges of cattle and horses. The cattle and horses must be held for draft, breeding, dairy, or sporting and held for 2 years or longer.

d. Sales or exchanges of other livestock. This livestock does not include poultry. It must be held for draft, breeding, dairy, or sporting and held for 1 year or longer.

e. Sales or exchanges of unharvested crops.

f. Cutting of timber or disposal of timber, coal, or iron ore.

g. Condemnations.

h. Casualties and thefts. These must have been a casualty to or theft of business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). The property must have been held longer than 1 year.

4. Treatment as Ordinary or Capital.

a. Combine all § 1231 gains and losses for the year.

b. If net § 1231 loss, it is an ordinary loss.

c. If net § 1231 gain,

(1) Ordinary up to amount of nonrecaptured § 1231 losses from previous years,

(2) The rest, if any, is long term capital gain

D. Depreciation Recapture.

1. If the taxpayer disposes of depreciable or amortizable property at a gain, he may have to treat all or part of the gain (even if otherwise nontaxable) as ordinary income.

a. To figure any gain that must be reported as ordinary income, the taxpayer must keep permanent records of the facts necessary to figure the amount of depreciation or amortization allowed or allowable on the property. This includes the date and manner of acquisition, cost or other basis, depreciation or amortization, and all other adjustments that affect basis.

b. On property acquired in a nontaxable exchange or as a gift, the records must also indicate the following information.

(1) Whether the adjusted basis was figured using depreciation or amortization you claimed on other property.

(2) Whether the adjusted basis was figured using depreciation or amortization another person claimed.

2. Section 1245 Property**.**

a. A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property.

b. Any gain recognized that is more than the part that is ordinary income from depreciation is a section 1231 gain.

c. Generally, section 1245 property includes personal property (either tangible or intangible) that is or has been subject to an allowance for depreciation or amortization. .

d. Section 1245 property does not include buildings and structural components.

3. Section 1250 Property.

a. Gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. Additional depreciation on section 1250 property is addressed later in this outline.

b. There will not be additional depreciation if any of the following conditions apply.

(1) The taxpayer figured depreciation for the property using the straight-line method or any other method that does not result in depreciation that is more than the amount figured by the straight-line method and the property was held longer than a year.

(2) The taxpayer chose the alternate ACRS method for the types of 15-, 18-, or 19-year real property covered by the section 1250 rules.

(3) The taxpayer disposed of residential rental property or nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made). These properties are depreciated using the straight-line method.

c. Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable.

4. Gain Treated as Ordinary Income

a. To find what part of the gain from the disposition of section 1250 property is treated as ordinary income, follow these steps.

(1) In a sale, exchange, or involuntary conversion of the property, figure the amount realized that is more than the adjusted basis of the property. In any other disposition of the property, figure the fair market value that is more than the adjusted basis.

(2) Figure the additional depreciation for the periods after 1975.

(3) Multiply the lesser of (1) or (2) by the applicable percentage, discussed later. **Stop here if this is residential rental property or if (2) is equal to or more than (1). This is the gain treated as ordinary income because of additional depreciation.**

(4) Subtract (2) from (1).

(5) Figure the additional depreciation for periods after 1969 but before 1976.

(6) Add the lesser of (4) or (5) to the result in (3). This is the gain treated as ordinary income because of additional depreciation.

(7) Use Part III, Form 4797, to figure the ordinary income part of the gain.

5. Additional Depreciation

a. If the taxpayer held section 1250 property longer than 1 year, the additional depreciation is the actual depreciation adjustments that are more than the depreciation figured using the straight-line method.

b. If the taxpayer held section 1250 property for 1 year or less, all the depreciation is additional depreciation.

c. The taxpayer will have additional depreciation if he used the regular ACRS method, the declining balance method, the sum-of-the-years-digits method, the units-of-production method, or any other method of rapid depreciation. The taxpayer will also have additional depreciation if he chooses amortization, other than amortization on real property that qualifies as section 1245 property.

d. Additional depreciation includes all depreciation adjustments to the basis of section 1250 property whether allowed to the taxpayer or another person (as for carryover basis property).

Example. Larry Johnson gives his son section 1250 property on which he took $2,000 in depreciation deductions, of which $500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the $500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of $1,000 on the property, of which $200 is additional depreciation, the son sells the property. At the time of sale, the additional depreciation is $700 ($500 allowed the father plus $200 allowed the son).

e. Depreciation allowed or allowable. The greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) is generally the amount to use in figuring the part of the gain to be reported as ordinary income. If you can show that the deduction allowed for any tax year was less than the amount allowable, the lesser figure will be the depreciation adjustment for figuring additional depreciation.

f. Figuring straight-line depreciation.

(1) The useful life and salvage value the taxpayer would have used to figure straight line depreciation are the same as those used under the depreciation method actually used.

(2) If the tax payer did not use a useful life under the depreciation method actually used (such as with the units-of-production method) or if you did not take salvage value into account (such as with the declining balance method), the useful life or salvage value for figuring what would have been the straight line depreciation is the useful life and salvage value you would have used under the straight line method.

(3) Salvage value and useful life are not used for the ACRS method of depreciation. Figure straight line depreciation for ACRS real property by using its 15-, 18-, or 19-year recovery period as the property's useful life.

g. Applicable Percentage

(1) The applicable percentage used to figure the ordinary income because of additional depreciation depends on whether the real property disposed of is nonresidential real property or residential rental property. The percentages for these types of real property are as follows.

(a) Nonresidential real property - the applicable percentage for periods after 1969 is 100%. For periods before 1970, the percentage is zero and no ordinary income because of additional depreciation before 1970 will result from its disposition.

(b) Residential rental property (80% or more of the gross income is from dwelling units) other than low-income housing, - the applicable percentage for periods after 1975 is 100%. The percentage for periods before 1976 is zero. Therefore, no ordinary income because of additional depreciation before 1976 will result from a disposition of residential rental property.

VIII. EXAMPLE: SALE OF PROPERTY DEPRECIATED UNDER THE MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS).

A. Background: Property depreciated after 1986 is depreciated using the Modified Accelerated Cost Recovery System (MACRS). Gain from property sold after being depreciated under MACRS is divided into two components and taxed at two different rates:

1. The portion of the gain attributable to “straight line” depreciation is generally taxed as unrecaptured I.R.C. § 1250 property at a 25% tax rate.

2. The remaining gain, normally attributable to appreciation, is taxed at the long-term capital gains rate of 20%.

B. The mechanics are as follows:

1. Begin with Form 4797. Report the sale of land in Section I (since it was not depreciable) see the Instructions to Form 4797, page 1.

2. Enter the sale of the structure in Section III of Form 4797.

   a. Line 19 is the description of the property.

   b. Line 20 - enter the gross sales price.

   c. Line 21 is the cost basis of the property.

   d. Line 22 is the allowed or allowable depreciation. This will be the total depreciation taken on the property under MACRS.

   e. Line 23 is simple math (subtract line 22 from line 21) to determine the basis adjusted for depreciation as required by I.R.C. § 1016.

   f. Line 24 is the gain from the sale of the property.

3. Next turn to the Summary of Part III - lines 30, 31, & 32.

   a. Line 30 is the total gain.

   b. Line 32 is simple math.

4. Transfer the amount from Line 32 to Part I, Line 6.

5. Follow the instructions in Parts I. The amount in Part I will go to Line 11 on the Schedule D.

6. The amount going to the Schedule D requires more effort.

   a. Particularly, focus on Line 25 of Part IV of Schedule D. This is "Unrecaptured Section 1250 Property."

   b. Complete the Unrecaptured Section 1250 Property worksheet in the Schedule D instructions. The worksheet is straight forward, and the result is the straight-line component of the depreciation will go on Schedule D, Line 19. Simply work the rest of the Schedule D, and its worksheet. The unrecaptured gain is taxed at 25%.

7. For more information or further clarification, see Pub. 544, Pub. 534, Form 4797 and instructions and Schedule D and instructions.

IX. EXAMPLE: SALE OF PROPERTY DEPRECIATED UNDER THE ACCELERATED COST RECOVERY SYSTEM (ACRS).

A. Background: Property depreciated after 1980, but prior to 1987, is depreciated using the Accelerated Cost Recovery System (ACRS). Gain from property sold after being depreciated under ACRS will be divided into three components and taxed at three different rates:

1. The portion of the gain attributable to "additional depreciation" is taxed as ordinary income. This is the "recaptured" component of the gain.

2. The portion of the gain attributable to "straight line" depreciation is generally taxed as unrecaptured I.R.C. § 1250 property at a 25% tax rate.

3. The remaining gain, normally attributable to appreciation, is taxed at the long-term capital gains rate of 15%.

B. The mechanics (using Tax Year 2002 Forms) are as follows:

1. Begin with Form 4797. Report the sale of land in Section I (since it was not depreciable) see the Instructions to Form 4797, page 1.

2. Enter the sale of the structure in Section III of Form 4797.

   a. Line 19 is the description of the property.

   b. Line 20 - enter the gross sales price.

   c. Line 21 is the cost basis of the property.

   d. Line 22 is the allowed or allowable depreciation. This will be the total depreciation taken on the property under ACRS.

   e. Line 23 is simple math (subtract line 22 from line 21) to determine the basis adjusted for depreciation as required by I.R.C. § 1016.

   f. Line 24 is the gain from the sale of the property.

   g. Go to Line 26. Real property is section 1250 property. Section 1250 property includes all real property that is subject to an allowance for depreciation. (See Pub. 544, page 24).

   h. On Line 26a you will enter the "additional depreciation." This is the amount of the actual depreciation adjustment that is more than the depreciation figure using the straight-line method. (e.g., Actual (ACRS) Depreciation LESS Straight-Line Depreciation = Additional Depreciation.)

EXAMPLE: Taxpayer has a property with an adjusted basis of $100,000 that he placed in service on 1 January 1986. He sells this property on 31 December 1999. It is 19-year ACRS property. He has depreciated this property for a full 14 years under ACRS. His total ACRS depreciation is $79,800. He has used the regular ACRS methods and he will have additional depreciation. Straight-line deprecation is calculated by dividing the depreciable basis of the property ($100,000) by the 19-year life of the property. Salvage value is not considered and 19 years is considered the useful life. Straight-line depreciation for this taxpayer is $73,684.21 (100,000/19 = $5,263.16 X 14 years). The additional depreciation is $6,115.79 ($79,800 - $73,684.21.)

i. Line 26b. The applicable percentage for residential rental property for periods after 1975 is 100%. So multiply the smaller of Line 24 - capital gain - or Line 26a - additional depreciation - by 100%. In the example above, multiply $6,115.19 by 100% and enter the entire $6,115.79 on Line 26b.

j. Line 26c is again simple subtraction. Skip lines 26d, 26e, since the property is residential rental property, and line 26f, assuming your client is not a corporation.

k. Line 26g simple math. You will merely carry the amount from Line 26b down to Line 26g.

3. Next turn to the Summary of Part III - lines 30, 31, & 32.

a. Line 30 is the total gain.

b. Line 31 is the amount from Line 26g

c. Line 32 is again simple math.

4. Transfer the amount from Line 31 to Part II Line 13 - the ordinary gains and losses.

5. Transfer the amount from Line 32 to Part I, Line 6.

6. Follow the instructions in Parts I and II.

a. The amount from Line 9 in Part I will go to Line 11, Column f on the Schedule D.

b. The amount from Part II will go the Form 1040, Line 14. The figure going to Line 14, Form 1040 will be self-explanatory. This amount is taxed as a component of ordinary income.

c. The amount going to the Schedule D requires more effort. Particularly, focus on Line 19 of Part IV of Schedule D. This is "Unrecaptured Section 1250 Property." Complete the Unrecaptured Section 1250 Property worksheet in the Schedule D instructions. The worksheet is straight forward, and the result is the straight-line component of the depreciation will go on Schedule D, Line 25. In the above example, the taxpayer would enter $73,684.21 on Schedule D, Line 19. Simply work the rest of the Schedule D and this amount will be taxed at 25%.

7. For more information or further clarification, see Pub. 544 (pages 24 & 25); Pub. 534 (page 19); Form 4797 and instructions and Schedule D and instructions.

C. ACRS Property and I.R.C. § 121

1. The taxpayer will be allowed to escape capital gain, including recapture on pre-May 7, 1997, depreciation, if he owns the home and he uses it as his principal residence for two of the 5 years preceding sale. All depreciation will be considered in determining the adjusted basis, but only post May 6, 1997, depreciation is considered to reduce the exclusion (I.R.C. § 121(d)(6)). See also worksheets in Pub. 523.

2. Note that neither I.R.C. 121 nor the regulations make any distinction about the method of depreciation used. They merely provide that the exclusion is reduced by post-May 6, 1997 depreciation. Depreciation taken after May 6, 1997, is treated as unrecaptured section 1250 property and is taxed at a 25% rate.

3. If any portion of the property were not used wholly as a principal residence for two of the five years preceding sale, e.g., a home that is part residence and part law office. The business portion would then be entered on a Form 4797 and taxed as business property.

X. STRATEGIES TO POSTPONE OR AVOID GAIN.

A. Like-Kind Exchange. Under section 1031 of the I.R.C., no gain or loss is recognized when business or investment property is exchanged for like-kind business or investment property.

1. The property exchanged must be similar in nature. Almost any exchange of real estate that was held for business or investment will qualify. For example, an exchange of a store for an apartment building would qualify.

2. If the taxpayer receives something of value that doesn't qualify for like-kind treatment, any gain resulting from the transaction is taxable (to the extent of the value of the non-qualifying property) but any loss resulting from the transaction is not recognizable.

3. Qualified intermediary. Taxpayers may transfer and receive property through a qualified intermediary (e.g., a real estate broker who locates and acquires like-kind property for the exchange) and still qualify for nonrecognition treatment.

a. A direct sale of property followed by a purchase of property of a like-kind never qualifies for nonrecognition of gain or loss under section 1031.

b. Taxpayers may transfer property to a real estate broker and the real estate broker may acquire property for the taxpayer, transfer the property to the taxpayer, and the transaction will qualify for like-kind treatment. See Treas. Reg. §1.1031(k)-1(g)(4) and IRS Pub. 946, Sales and Other Dispositions of Assets. Revised I.R.C. § 121.

B. Reconvert to Principal Residence

1. A taxpayer may use revised section 121 to exclude some gain (other than for nonqualified use or from post-May 6, 1997 depreciation) from the sale of a rental property if they move back into it and use it as a principal residence for at least two of the five years preceding the property's sale (the taxpayer need not live in the property the full two years if the move is for reasons related to health, work, or unforeseen circumstances).

2. This method is significantly less effective than in prior years due to the requirement to account for and pay tax on gain related to periods of nonqualified gain.

3. Depreciation taken after May 6, 1997 is not excludable under revised section 121.

XI. CONCLUSION.

CHAPTER M

TAX ASPECTS OF REAL PROPERTY

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TAX ASPECTS OF REAL PROPERTY

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. Internal Revenue Code of 1986.

B. Taxpayer Relief Act of 1997.

C. American Recovery and Reinvestment Tax Act of 2009.

D. Treasury Regulations.

E. IRS Publications.

1. Pub. 523, Selling Your Home.

2. Pub. 527, Residential Rental Property.

3. Pub. 530, Tax Information for First-Time Homeowners.

4. Pub 534, Depreciating Property Placed in Service Before 1987.

5. Pub. 535, Business Expenses.

6. Pub. 551, Basis of Assets.

7. Pub. 678, Volunteer Assistors Guide.

8. Pub. 925, Passive Activity and At-Risk Rules.

9. Pub. 936, Home Mortgage Interest Deduction.

10. Pub 946, How to Depreciate Property

F. Price, *Price on Contemporary Estate Planning*, (1992).

G. Weinstock, *Planning an Estate* (1997).

H. George L. Hancock, Jr., *Deductibility of Points*, 5 LAMPLIGHTER NO. 2, at 3 (Summer 1994).

I. Thomas K. Emswiler, *Tax Aspects of Renting and Then Selling a Residence*, ARMY LAW., Oct. 1995, at 3.

J. Forms: Form 1040, Schedule A, Schedule E, Form 982, Form 4562, Form 8582, Form 4797.

PART A – HOME OWNERSHIP

II. INTRODUCTION.

Home ownership – buying, owning, and selling – is perhaps the most significant investment the service member, as well as most Americans, make. Home ownership provides not only shelter from the elements, but can result in several tax consequences for the taxpayer arising from the purchase, the year-to-year ownership, and the sale of the home.

III. THE INITIAL DECISION - TO RENT OR BUY.

A. It is not all about tax breaks (but they sure do help).

B. Renting:

1. Pros:

a. Flexibility (can relocate easily)

b. Can invest money elsewhere (market)

c. No upkeep expenses (drippy faucets, broken windows, etc.)

2. Cons:

a. No equity

b. Annual rent increase could outpace inflation

C. Buying:

1. Pros:

a. Tax-break: Deductions

(1) Mortgage interest

(2) Home equity loan interest

(3) Property taxes

b. Potential for tax free or mostly free capital gain (I.R.C. § 121)

c. Emotional Satisfaction

2. Cons:

a. Property tax and upkeep

b. Mortgage costs

c. Less flexibility

d. Could lose principal

D. Make a fully informed decision - Do your homework!!

1. How much is the tax deduction actually worth?

2. What is the property's potential for appreciation?

3. What is the property's condition?

4. What is my total outlay for my projected period of occupancy?

IV. TAX CONSEQUENCES OF BUYING A HOME.

A. Determining the Original Basis of Residential Property. See I.R.C. § 1012 & IRS Publication No. 551, Basis of Assets.

1. The original basis of a home is its cost (purchase price) including any debt assumed or incurred. (I.R.C. § 1012).

2. If the home was constructed, its original basis is the cost of land plus the amount to construct the residential building.

3. A basis other than cost must be used if the property was acquired by inheritance, gift or received from spouse incident to divorce (I.R.C. §§ 1014, 1015; 1041) (*see Godlewski v. CIR*, 90 T.C. 200 (1988). Husband and wife purchase home jointly for $32,200 in 1973. Property settlement agreement provided that wife would convey her interest in home to husband for $18,000. After paying wife, husband sold home to third party for $64,000 in 1984. IRS used original basis ($32,200) to figure gain. Taxpayer contended that he was entitled to increase his basis by amount he paid to buy wife out. Tax Court disagreed--I.R.C. § 1041(b)(2) and Temp. Treas. Reg. § 1.1041-1T(d)A-11 preclude transferee spouse from increasing basis even in a bona fide sale when I.R.C. § 1041 applies.).

4. Taxpayers must maintain accurate records showing the original basis of the property and all adjustments. The burden to prove basis is with the taxpayer.

B. Tax Treatment of Property Purchase Costs.

1. Costs Included in Basis:

a. Taxpayers can include in the basis of property the settlement fees and closing costs that are for buying it. A settlement fee or closing cost is considered to be for buying the property if you would have paid it even if you had paid cash.

b. Settlement fees or closing costs that you can include in the basis of your property include:

(1) Abstract fees,

(2) Charges for installing utility services,

(3) Legal fees (including title search and preparing the sales contract and deed),

(4) Recording fees,

(5) Surveys,

(6) Transfer taxes,

(7) Title insurance, and

(8) Any amount the seller owes that the buyer agrees to pay.

2. Certain costs of purchasing property may be deducted in the year of purchase.

a. Real estate taxes (I.R.C. § 164(d)).

(1) Real estate taxes are deductible to the extent they are imposed on the taxpayer.

(2) The seller is treated as paying the property taxes up to, but not including the date of sale.

(3) The buyer is treated as paying the taxes beginning with the date of sale, despite the property tax accrual or lien dates under local law.

Example: Assume MAJ & Mrs. Home Buyer's real property tax year is the calendar year and the tax on a home they bought on May 4 was $732. Because they owned this home for 242 days (May 4 - Dec 31, including purchase date), their real estate tax deduction is 242/365 of $732, or $485.

Variance: Seller pays all:
I.R.C. § 164(d) allocates deduction of $247 to Seller and $485 to Buyer.
Buyer decreases adjusted basis by $485
Seller decreases amount realized by $485

Variance: Buyer pays all:
I.R.C. § 164(d) allocates deduction of $247 to Seller and $485 to Buyer.
Buyer increases adjusted basis by $247
Seller increases amount realized by $247

b. Mortgage Interest. (I.R.C. § 163(h)(3)).

(1) At settlement, purchaser is usually charged for daily interest from the day of settlement on the house until the end of the month. This may be claimed for the year in which house purchased.

(2) Mortgage lenders may neglect to report this - be sure to check settlement documents.

c. Points.

(1) Defined: charge by lenders above regular interest rate and must be stated as percentage of the mortgage loan. For example, one point on a $100,000 mortgage loan is $1,000.

(2) Possible tax treatments of points on home loans:

(a) Deductible as a mortgage interest expense, in full, in year paid;

(b) Deductible in installments over the life of the loan.

(3) Generally, prepaid interest paid as points must be spread over the life of a mortgage. (I.R.C. § 461(g)(1)).

(a) See Rev. Proc. 87-15, 1987-1 C.B. 624 for the method for determining the amount of points allocable to, and deductible in, each taxable year.

(b) To determine how much to deduct each year, divide the cost of the points by the total number of loan payments and multiply the quotient by the number of payments made in the tax year.

(4) You can fully deduct the points in the year of purchase if (1) your loan is secured by your main home; (2) points are generally imposed in the local real estate market and the amount you paid is no more than what is generally paid in the local real estate market; (3) you pay them to purchase, construct or improve your home; (4) they were computed as a percentage of the principal amount of the mortgage; (5) the amount paid is clearly shown on the HUD-1 as points; and (6) they are paid with funds other than those obtained from the lender (pre-1994 alternative--a moving expense deduction). (I.R.C. § 461(g)(2)).

Note: IRS has relaxed "paid with funds other than those obtained from the lender" requirement.

Example: In the current tax year Major and Mrs. Homebuyer bought a $100,000 home with $10,000 cash out of savings and a $90,000 30-year loan. The lender charged them 3 points ($2,700), adding these to the loan amount, bringing the total loan to $92,700. Under Rev. Proc. 94-27, the Homebuyers may deduct the entire $2,700 on their current year tax return.

(5) Points paid to refinance a mortgage, regardless of how they are paid, are not deductible in full in the year paid unless they are paid in connection with the improvement of a home. (Rev. Proc. 94-27).

(6) If the points paid represent interest, but the points were higher than those generally charged in the local real estate market, then the amount of points in excess of the norm must be prorated over the life of the loan.

(7) If the points represent compensation for services that ordinarily are stated separately on the settlement statement (i.e., appraisal fees, inspection fees, title fees, attorney fees and property taxes), they are not interest and cannot be deducted either in the year of purchase or over the life of the loan. Such points may be added to the home's basis.

(8) Only the buyer may deduct seller-paid points as interest. Buyer lowers basis by the amount of the seller-paid points.

d. VA/FHA Loan Origination Fees. Deductible if the Uniform Settlement Statement (Form HUD-1) clearly designates the amounts as points. This revenue procedure expressly includes VA and FHA loan origination fees as examples of items clearly designated as points. (Rev. Proc. 94-27). This clarifies and reverses a position taken by the IRS in Rev. Rul. 67-297, 1967-2 CB 87 that "Points" paid in acquiring a home mortgage loan guaranteed by the VA or FHA are for services rendered and as such aren't deductible as interest.

3. Some costs incurred in purchasing a home are neither deductible nor added to basis.

a. Fire insurance premiums,

b. Charges for utilities,

c. Rent for occupying the home before closing,

d. Homeowners association fees,

e. Other fees or charges for services concerning occupying the home, and

f. Charges connected with getting or refinancing a mortgage loan, such as:

(1) FHA mortgage insurance premiums and VA funding fees, (currently deductible through December 31, 2016) (Not sure whether this will be extended.)

(2) Loan assumption fees,

(3) Cost of a credit report, and

(4) Fee paid for an appraisal required by the lender.

C. First-Time Homebuyer Tax Credit (26 USC §36) (Note: This applies to purchases that were made during or prior to 2010 (military were allowed an extra year until 2011). This section has been intentionally left in the outline as a reference in case the tax credit recapture provisions apply in your case.)

1. Amount.

   a. A credit of the lesser of 10% of the purchase price of the residence or

   b. $8,000 ($4,000 if married filing separately) for a first-time homebuyer. If two or more individuals (not married to each other) purchase the residence, the total credit for all individuals is limited to $8,000.

   c. $6,500 ($3,250 if married filing separately) for a long-time resident.

   d. $7,500 for purchases between April 8, 2008 and December 31, 2008.

2. Eligibility.

   a. First-time homebuyer. A first time homebuyer is any individual if the individual (and spouse, if married) had no ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence. An individual may still have an ownership interest in a rental property and qualify as a first-time homebuyer.

   b. Long-time resident. For purchases after November 7, 2009. A long-time resident must have owned and used the same home as the principal residence for at least five consecutive years of the eight-year period ending on the date the resident purchases the new principal residence. For an eligible taxpayer who, for example, bought a home on Nov. 30, 2009, the eight-year period would run from Dec. 1, 2001, through Nov. 30, 2009.

   c. <u>Purchase the principal residence before May 1, 2010 or enter into a contract to purchase the principal residence before July 1, 2010 with a settlement date prior to September 1, 2010</u>.

   d. Modified AGI for purchase <u>prior to November 6, 2009</u> must be less than $75,000 ($150,000 if married, filing jointly). Credit amount is fully phased out at $95,000 ($170,000).

e. Modified AGI for purchases after November 6, 2009 must be less than $125,000 ($225,000 if married, filing jointly). Credit amount is fully phased out at $145,000 ($245,000).

f. Must acquire the home and use it as the principal residence for at least three years. Note: this provision, which requires recapturing the credit if the home ceases to be the principal residence during the three year period, is waived for military members who cease using the home as a principal residence because of being transferred pursuant to military orders outside of the area.

g. May not dispose of the principal residence during the year of purchase.

3. Recapture of the $7,500 credit for purchases between April 8, 2008 and December 31, 2008.

a. Credit repaid in equal installments over 15-year period

b. Recapture period begins in the second taxable year after purchase. (i.e., if purchase occurs in 2010, first recapture payment occurs in 2012).

c. If principal residence is sold before credit is fully repaid, entire unrecaptured amount becomes due in the year of sale.

d. For purchases between January 1, 2009 and November 30, 2009, there is no recapture, PROVIDED the home is used as the principal residence for the first 36 months following the purchase. The entire credit is recaptured if the home ceases to be used as the principal residence before the end of the 36 month period.

4. Military exceptions.

a. Members of the military serving **outside** the U.S. have an extra year to buy a principal residence in the U.S. and qualify for the credit.

(1) A member must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2011 and must close on the purchase on or before June 30, 2011.

(2) This applies to members who serve on qualified official extended duty service outside of the United States for at least 90 days during the period beginning after Dec. 31, 2008, and ending before May 1, 2010.

b. The recapture provision is waived for a member who ceases to use the home as the principal residence during the three year period because of being transferred pursuant to military orders outside of the area.

5. Filing requirements.

a. MUST FILE A PAPER RETURN

b. File a Form 5405, *First Time Homebuyer Credit and Repayment of the Credit.*

c. Properly executed settlement statement/Form HUD-1.

V. TAX CONSEQUENCES OF OWNING A HOME.

A. Deductions.

1. Home mortgage interest deduction rule (I.R.C. § 163(h)(2)(D) and I.R.C. § 163(h)(3)(A)). Qualified residence interest is deductible as an itemized deduction.

2. Qualified residence interest (I.R.C. § 163(h)(3)). Qualified residence interest means interest paid on "acquisition indebtedness" or "home equity indebtedness" on a "qualified residence."

   a. "Acquisition indebtedness" is a debt used to acquire, construct, or substantially improve a home provided the debt is secured by a qualified residence.

      (1) Acquisition indebtedness may not exceed $1,000,000 ($500,000 for a married person filing a separate return) (I.R.C. §163(h)(3)(B)).

      (2) Refinancing is treated the same as original acquisition debt but only up to the principal amount of the acquisition debt outstanding immediately before the refinancing. Once the original acquisition debt reaches $0, the homeowner is limited to deductions for interest on $100,000 of home-equity debt.

   b. "Home equity indebtedness" is any indebtedness secured by a qualified residence to the extent of the lesser of the fair market value of the house, or $100,000 ($50,000 for married individual filing separately) (I.R.C. §163(h)(3)(C)). Allows homeowners to deduct interest on home equity loans even if the loan proceeds are used for personal purposes.

   c. Acquisition and home equity indebtedness cannot exceed a total of $1,100,000 for both qualified residences.

Example: Taxpayer bought a home and took out a mortgage of $50,000 ("acquisition indebtedness"). He reduced the mortgage by $10,000 over the years and now wants to refinance the home when it is worth $150,000. He wants to borrow $150,000, pay off the old mortgage of $40,000, and use the rest of the loan for other purposes. The breakout of the transaction is as follows:

- $40,000 treated as acquisition indebtedness and the interest attributable to it is deductible
- $100,000 treated as home equity debt and the interest attributable to it is deductible
- $10,000 neither acquisition nor equity debt - interest on this amount is nondeductible

Thus, about 93.3% of the interest is deductible.

d. "Qualified residence" includes the taxpayer's principal residence (same definition as I.R.C. § 121) and one other home (I.R.C. §§ 280A(d)(1), 163(h)(4)).

e. "Residence" is determined based on facts and circumstances. A "residence" generally includes houses, condominiums, cooperatives, mobile homes, houseboats, or trailers that contain sleeping space, toilet and cooking facilities. (Reg. § 1.163-10T(f)(1)(ii); Reg. § 1.163-10T(p)(3)(ii).

f. Debt must be secured by a qualified residence (I.R.C. § 163(h)(3)(B)(i)(II)). See also PLR 9418001 (interest on taxpayer's home purchase loan was secured by interest in rental property not home purchased and was not deductible).

g. Special grandfather rule exists for pre-October 13, 1987, indebtedness. If debt secured by qualified residence was incurred prior to this date, it is not subject to $1,000,000 acquisition debt limit (I.R.C. § 163(h)(3)(D)).

h. Taxpayers who have used mortgage loans for a purpose other than to purchase, construct, or substantially improve the home should consult IRS Pub. 936, Limits on Home Mortgage Interest Deduction.

3. Real estate taxes. "[T]he following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: (1) State and local, and foreign, real property taxes. (I.R.C. § 164).

   a. Most homeowners are cash basis taxpayers allowed to deduct taxes only in the year in which they actually accrue and are paid (I.R.C. § 164(a)).

   b. Real estate taxes placed in escrow may exceed those actually paid by the lender to the taxing authority. Only those actually paid by the lender to the taxing authority may be deducted.

   c. A taxpayer generally may not deduct assessments for local benefits, such as for construction of streets, sidewalks, or water and sewage system, which tend to increase the value of the property (I.R.C. § 164(c)(1)). These costs must be added to the cost basis.

4. Casualty and theft losses (I.R.C. § 165(c)).

   a. Casualty. To qualify for the deduction the loss must arise from a "fire, storm, shipwreck or other casualty, or from theft (I.R.C. § 165(c)(3)).

   b. Casualty is not defined in the Internal Revenue Code. Case law defines casualty as the total or partial destruction of property, resulting from an identifiable event of a sudden, unexpected, or unusual nature.

   c. If a taxpayer's residence is located in an area declared by the President to be a "disaster area" and the taxpayer is ordered by state or local government within 120 days of the disaster determination to demolish or relocate the residence because it has been rendered unsafe for use as a residence as a proximate result of the disaster, any loss resulting from the demolition or relocation of the residence is deemed to be a loss arising from a casualty (I.R.C. § 165(k)).

   d. Theft includes larceny, embezzlement, robbery and other criminal appropriations of property (Treas. Reg. § 1.165-8(d)).

   e. Deduction is available only to the extent loss exceeds $100 (for each incident) and to extent all casualty losses for year exceed 10% of AGI (I.R.C. § 165(h)).

f. Reimbursements for casualty and theft losses offset losses.

B. Adjustments to Basis (I.R.C. § 1016).

1. The basis of property is adjusted for any expenditure, receipt, loss or other item properly chargeable to capital account, including improvements and betterments made to the property (Reg. § 1.1016-2(a)). See also I.R.C. § 263, *Capital Expenditures*. *See* examples in Appendix A.

a. An improvement materially adds value, prolongs life, or adapts home to a new use.

b. The amount added to the basis is the actual cost of the improvement plus debt incurred.

2. Local property assessments.

3. Casualty losses.

4. Depreciation allowed - if home had been rented previously.

5. Gain previously deferred. *See* material pertaining to I.R.C. § 1034.

C. Nondeductible Expenses.

1. Utility fees and assessments for services such as water, sewage, and trash or garbage collection.

2. Expenses for maintenance and repairs.

3. Insurance (including fire and ~~mortgage insurance~~) premiums. (Note: Mortgage insurance premiums deductible through Dec 31, 2014 – legislation pending that may extend the deduction through Dec 31, 2015.)

4. Loan assumption fees, credit reports, and appraisals.

VI. TAX CONSEQUENCES OF SELLING A HOME.

A. Losses sustained on the sale of a personal residence are not deductible (I.R.C. § 165, Treas. Reg. § 1.165-9).

1. If a residence is converted to rental property, a loss will be allowed, but the taxpayer must compute the amount of the loss from the lesser of the adjusted basis or the fair market value at the time of the conversion (Treas. Reg.. § 1.165-9).

2. Taxpayer has option to elect out of section 121. Allows taxpayer to treat an otherwise qualifying property as a rental. (I.R.C. § 121(f)).

B. Gain derived from the sale of a personal residence is taxable unless deferred or excluded.

C. If at least one payment is to be received after the close of the tax year, the gain may be reported in installments (I.R.C. § 453; IRS Publication No. 537, Installment Sales).

1. The installment method is a special method of reporting gains (not losses) from sales of property when at least one payment is received in a tax year after the year of sale. Under the installment method, gain from an installment sale is prorated and recognized over the years in which payments are received. (I.R.C. § 453).

2. The installment method may only be used for reporting gain from nondealer sales of property other than inventory. Dealer dispositions of property may not be reported under the installment method (I.R.C. § 453(b)(2)(A)).

3. Gain Calculation. For nondealer dispositions that are not subject to the I.R.C. §§ 1245 or 1250 recapture provisions, the amount of gain from an installment sale that is taxable in a given year is calculated by multiplying the payments received in that year by the gross profit ratio for the sale (I.R.C. § 453(c)).

a. The gross profit ratio is equal to the gross profit on the sale divided by the total contract price.

b. The gross profit is equal to the selling price of the property minus its adjusted basis. The selling price of the property is not reduced by any existing mortgage or encumbrance, or by any selling expenses, but is reduced by interest that is imputed under I.R.C. § 483.

c. The total contract price (denominator of gross profit ratio) is equal to the selling price minus that portion of qualifying indebtedness assumed by, or taken subject to, the buyer that does not exceed the seller's basis in the property (adjusted to reflect commissions and other selling expenses) (Temporary Reg. §15A.453-1(b)(2)).

Example. On December 1, 2016, a calendar year taxpayer sells his *personal* automobile for a total contract price of $2,500. His basis in the car is $2,000. His anticipated gross profit from the sale is $500. He receives a $1,000 down payment, with the balance due in monthly installments of $100 each, plus interest at the applicable federal rate, beginning on January 1, 2017. Under the installment method, the taxpayer must report $200 ($1,000 x ($500 ÷ $2,500)) as income in 2015, $240 ($1,200 x ($500 ÷ $2,500)) in 2017, and $60 ($300 x ($500 ÷ $2,500)) in 2018.

(1) Income from an installment sale is reported on Form 6252 , "Installment Sale Income," which must be filed with the tax return in the year of sale and in each year payments are received.

(2) In the case of installment dispositions of real or personal property to which I.R.C. § 1245 or 1250 applies, any recapture income must be reported in the year of disposition, whether or not an installment payment is received in that year. The ordinary income amount reported in the year of sale is added to the property's basis, and this adjusted basis is used in determining the remaining profit on the disposition. The remaining profit amount is used to compute the gross profit percentage to be applied to each installment payment. (I.R.C. § 453(i)).

D. Exclusion of gain on the sale of a principal residence. (I.R.C. § 121).

1. An individual taxpayer may exclude from income up to $250,000 of gain realized from the sale or exchange of his home if:

a. During the 5 years ending on the sale date, he owned and used it as a principal residence for periods aggregating at least 2 years (I.R.C. §Sec. 121(a)); and

b. Within the 2-year period ending on the sale date, there was no other home sale (or exchange) by the taxpayer to which the exclusion applied. (I.R.C. § 121(b)(3)).

c. The gain is not allocable to a period of "nonqualified use." (I.R.C. §121(b)(4)(C)).

2. Married taxpayers may exclude up to $500,000 of gain from the sale of a principal residence if they file a joint return for the year in which the home is sold and:

a. Either spouse owned the property for periods aggregating two years or more during the five year period ending on the date of the sale of the property;

b. Both spouses used the property as a principal residence for periods aggregating two years or more during the five year period ending on the date of the sale of the property; and

c. Neither spouse used the home sale exclusion on a previous sale (or exchange) of a home during the two-year period ending on the sale date. (I.R.C. § 121(b)(2); Treas. Reg. § 1.121-2(a)(3)(i)).

d. Use of the home need not have occurred while the spouses were married.

NOTE: If the above conditions are met, up to $500,000 of gain may be excluded (instead of up to $250,000) even though only one spouse owns the home.

e. The husband and wife won't qualify for the full $500,000 exclusion unless both spouses meet the two-out-of-five-year use requirement, and neither spouse previously used the exclusion in the two year period ending on the sale date.

Example: Tom owned and used a home as his principal residence for ten years. One year before she married Tom, Winnie began using Tom's home as her principal residence. Eighteen months after their marriage, Tom sells the home at a gain of $400,000. Neither Tom nor Winnie have previously sold another home. Tom can exclude the entire $400,000 gain from the sale of his home on their joint return since he owned it and both he and Winnie used it as their principal residence for at least two of the five years before the sale. (RIA – Making the Most of the Homesale Exclusion)

Example: Jane sells her principal residence this December at a $100,000 gain. She is single at that time, and qualifies for and claims the homesale exclusion. She marries James in May of next year and moves into the home that has been his principal residence for the 20 years of his bachelorhood. If James sells the home next June, the full $500,000 exclusion doesn't apply because Jane sold a home within the two-year period ending on the date that James sold his home. James, may, however, exclude up to $250,000 of his gain. Jane may qualify for a partial exclusion. (RIA – Making the Most of the Homesale Exclusion)

f. The gain is not allocable to a period of "nonqualified use." (I.R.C. §121(b)(4)(C)).

3. Availability of exclusion to joint owners who file separate returns. If taxpayers jointly own a principal residence but file separate returns, each owner may exclude up to $250,000 of gain that is attributable to his interest in the property, if he otherwise meets the I.R.C. § 121 requirements. (Treas. Reg. § 1.121-2(a)(2)).

Example: Unmarried taxpayers Alan and Barbara own a house as joint owners. Each owns a 50% interest in the house. They sell the house at a gain of $256,000 after owning and using it as their principal residence for two full years. Alan and Barbara may each exclude $128,000 of gain. (Treas. Reg. § 1. 121-2(a)(4), Ex. 1)

4. Involuntary conversions treated as sales for purposes of the homesale exclusion. The destruction, theft, seizure, requisition, or condemnation of a home is treated as a sale for purposes of the homesale exclusion. (I.R.C. § 121(d)(5)(A), Treas. Reg. § 1.121-3(d)(1)).

E. Gain from a period of <u>nonqualified use</u> may not be excluded.

1. Nonqualified Use means the period of time during which the property was not used as a principal residence and

a. Occurs after December 31, 2008.

b. Does not include the five-year period ending on the date of sale after the date the property is last used as the primary residence.

c. Does not include any period (up to 10 years) during which the military member is serving on qualified official extended duty (active duty) at least 50 miles from the property pursuant to military orders.

d. Any other period of temporary absence (up to 2 years) due to change of employment, health, or other unforeseen circumstances.

2. The fraction of gain that may not be excluded is calculated as the fraction

a. The total period of nonqualified use after 2008, divided by

b. The total period of home ownership.

Example: John and Mary purchased their principal residence for $350,000 in January 2006 and lived there until January 2008, when they converted it to a rental property. In January 2010, they moved back into the home and made it their principal residence. In January 2011, they sold the home for $600,000.

John and Mary are eligible to exclude gain, because they owned and used the property as their principal residence for two of the five years preceding its sale (Jan 2007 – Jan 2008 and Jan 2010 – Jan 2011). One year, though, (Jan 2009 – Jan 2010) out of the five years they owned the property, the use of the property is considered nonqualified use. Of their total gain ($250,000), 1/5 may not be excluded ($50,000).

(Note: See also subsection N., below, for a discussion on recapture of depreciation while a rental property.)

F. What is a principal residence for purposes of the homesale exclusion?

1. The homesale exclusion applies only if the property has been owned and used by the taxpayer as his principal residence for at least two of the five years ending with the sale date. (I.R.C. §. 121(a)).

a. In deciding whether a property was used as the taxpayer's principal residence, the first step is to determine whether the property is a residence before considering whether the property was used by the taxpayer as his principal residence.

b. There is no requirement that a principal residence be located in the U.S. for the homesale exclusion to apply. Thus, assuming the I.R.C. § 121 tests are met, a profit on the sale of a principal residence located outside of the U.S. also qualifies for the up-to-$250,000/$500,000 exclusion. However, the homesale exclusion does not apply to any sale by an individual subject to I.R.C. § 877(a)(I) (rules related to expatriation to avoid tax). (I.R.C. § 121(e)).

2. When is property a residence?

a. The regulations say that whether property is used by the taxpayer as his residence depends on all the facts and circumstances.

b. The regulations also provide that a property used by the taxpayer as his residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in I.R.C. § 216(b)(1) and I.R.C. § 216(b)(2)). (Treas. Reg. § 1.121-1(b)(1)).

(1) Although the regulations don't consider the more fundamental question of what is a residence, the issue was addressed in an '80 ruling that said a property (e.g., a yacht) can be a residence only if it contains facilities for cooking, sleeping, and sanitation. (IRS Letter Ruling 8015017).

(2) The term residence does not include personal property, such as furniture, that is not a fixture under local law. (Treas. Reg. § 1.121-1(b)(2)).

3. Which of several residences is the taxpayer's principal residence?

a. Where a taxpayer uses more than one property as a residence, the question of which one is his principal residence depends on all the facts and circumstances in each case.

b. If the taxpayer alternates between two residences, the property he occupies a majority of the time ordinarily will be considered his principal residence. (Treas. Reg. § 1.121-1(b)(2)).

c. In addition to the taxpayer's use of the property, other relevant factors in determining which or his residences is his principal residence, include:

(1) his place of employment;

(2) the principal place of abode of his family members;

(3) the address listed on his federal and state tax returns, driver's license, car registration, and voter registration card;

(4) his mailing address for bills and correspondence;

(5) where his banks are located; and

(6) the location of the religious organizations and recreational clubs he belongs to. (Treas. Reg. § 1.121-1(b)).

4. Homesale exclusion is available for separate sales of home and surrounding land.

a. A taxpayer who owns a home situated on a large lot or on substantial acreage may decide to sell off some of the land but to keep using the rest as his residence.

b. Alternatively, he may sell the home plus some acreage first and the balance of the vacant land later.

c. Gain on the sale of the vacant land qualifies for the I.R.C. § 121 exclusion if:

(1) the taxpayer otherwise qualifies for the exclusion;

(2) the vacant land is

(a) adjacent to the land containing the taxpayer's dwelling unit, and

(b) owned and used by the taxpayer as part of his principal residence for at least two of the five years preceding the sale; and

(c) the dwelling unit is sold in a transaction qualifying for the homesale exclusion within two years before or two years after the sale date of the vacant land. (Treas. Reg. § 1.121-1(b)(3)(i)).

(3) Only one maximum exclusion of $250,000 ($500,000 for qualifying joint filers) applies to the combined sales of the vacant land and dwelling unit.

G. Ownership and use requirements.

1. In order to exclude gain, the taxpayer must meet the ownership and use tests. To do this, the taxpayer must, during the 5-year period ending on the date of sale,

a. Owned the home for at least 2 years (the ownership test),and

b. Lived in the home as the main residence for at least 2 years (the use test). (I.R.C. § 121(a), IRS Pub. 523).

2. The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 x 2).

3. The requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange.

4. In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

H. Two-year ownership and use periods need not be continuous.

1. The required two-year ownership and use periods during the five-year period ending on the date of the sale need not be continuous.

2. The periods also don't have to be measured in years.

3. A taxpayer meets the tests if he shows that he owned and lived in the property as his main home for either 24 full months or 730 days (365 x 2) during the five-year period. (Treas. Reg. § 1.121-1 (c)(1)).

Example: For all of Year 1, Alvera lived in a house that her mother owned. In Jan. of Year 2, Alvera inherited the house from her mother, moved out of the house, and held it for investment. In June of Year 4, she moved back into the house and used it as her principal residence until she sold it at a $150,000 profit on Dec. 31, Year 5. Alvera can exclude her gain (assuming she didn't use the exclusion on another home sale during the two year period ending on the sale date) even though she didn't live in the house for two years in a row. Her use periods in the aggregate (31 months) exceeded the minimum 24-month requirement, and her continuous ownership period (48 months) also exceeded the minimum 24-month requirement.
(RIA – Making the Most of the Homesale Exclusion)

4. In establishing whether a taxpayer has satisfied the two-year use requirement, occupancy of the home is required. However, short temporary absences for vacations or other seasonal absences, even if the taxpayer rents out the property during the absences, are counted as periods of use. (Treas. Reg. § 1.121-1 (c)(2)(i)). Two-month vacations are short temporary absences, but a one-year stay abroad (e.g., while on sabbatical) is not. (Treas. Reg. § 1.121-1(c), Exs. (4) and (5)).

I. Two-year ownership and use periods need not be satisfied simultaneously. A taxpayer may meet the homesale exclusion's ownership and use tests during different two-year (or 24-month) periods as long as both tests are met during the five-year period ending on the date of the sale. (Treas. Reg. § 1.121-1(c)(1)).

Example: Starting in Year 1, Helen lived in a rented apartment. The apartment building was later changed to a condominium and Helen bought her apartment on Dec. 1, Year 6. In Year 7, she became ill and on Apr. 14 of that year moved to her daughter's home. On July 10, Year 9, while still living in her daughter's home, Helen sold her condominium apartment at a $200,000 gain. Helen can exclude her gain because she met the ownership and use tests. During the 5-year period ending on the sale date (July 11, Year 4, to July 10, Year 9), Helen owned her apartment from Dec. 1, Year 6, to July 10, Year 9 (over 2 years). She lived in the apartment from July 11, Year 4 to Apr. 14, Year 7 (over 2 years). (RIA – Making the Most of the Homesale Exclusion)

J. Tacking of ownership and use periods from previous homes.

1. I.R.C. § 1033 Involuntary Conversion. For purposes of the two-out-of-five-year ownership and use test, a taxpayer who acquires a home as a replacement for a principal residence involuntary converted under I.R.C. § 1033, is treated as owning and using the replacement home as his principal residence during any period of time that he owned and used the converted property as his principal residence. (I.R.C. § 121(d)(5)(C); Treas. Reg. § 1.121-4(d)(3)).

2. I.R.C. § 1034 Rollover. Under the homesale rollover rules of former I.R.C. § 1034 that were repealed, generally effective for sales and exchanges after May 6, '97, homesellers could defer gain on the sale of a principal residence if they timely reinvested the adjusted sales price (amount realized less fixing up expenses) of the old residence in a replacement principal residence. The replacement period generally began two years before the sale of the residence and ended two years afterwards. For purposes of the two-out of-five year ownership and use tests to qualify for current law's $250,000/$500,000 exclusion, a taxpayer whose purchase of a replacement residence resulted in deferral of gain under the rollover rules that applied to sales and exchanges before May 7, '97 may “tack on” his ownership and use of the old residence to his ownership and use of the replacement residence. (I.R.C. § 121(g); Treas. Reg. § 1.121-4(h)).

K. Dollar Limitations.

1. $250,000 (I.R.C. § 121(b)(1), Treas. Reg. § 1.121-2(a))

2. $500,000 exclusion for joint filers. In the case of a husband and wife who file a joint return for the tax year of the sale or exchange of the property, the $250,000 limitation is increased to $500,000 if: (I.R.C. § 121(b)(2)(A), Treas. Reg. § 1.121-2(b)),

a. Either spouse meets the *ownership* requirements described in section 121(a) with respect to the property (I.R.C. § 121(b)(2)(A)(i), Treas. Reg. § 1.121-2(b)(1)(i)),

b. Both spouses meet the *use* requirements described in section 121(a) with respect to the property (I.R.C. § 121(b)(2)(A)(ii), Treas. Reg. § 1.121-2(b)(1)(ii)), and

c. Neither spouse is ineligible for the benefits of the exclusion with respect to the property by reason of the one sale every two years rule contained in section 121(b)(3) (I.R.C. § 121(b)(2)(A)(iii), Treas. Reg. § 1.121-2(b)(1)(iii)).

Example: Married Taxpayers A and B own a house as joint owners, each owning a 50 percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years. The gain realized from the sale is $256,000. A and B meet the requirements of section 121 and file a joint return for the year of the sale. The entire amount of gain from the sale of their principal residence is excluded from gross income because the gain realized from the sale does not exceed the limitation amount of $ 500,000 available to taxpayers filing a joint return. (Treas. Reg. § 1-121-2(4) Example (2)).

Example: During 1999, married taxpayers H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. H and W file a joint return for the year of the sales. The gain realized from the sale of H's residence is $ 200,000. The gain realized from the sale of W's residence is $ 300,000. Because the ownership and use requirements are met for each residence by each respective spouse, H and W are eligible to exclude up to $ 250,000 of gain from the sale of each of their residences. However, W may not use H's unused exclusion to exclude gain in excess of her exclusion amount. Therefore, H and W must recognize $ 50,000 of the gain realized on the sale of W's residence. (Treas. Reg. § 1-121-2(3) Example (3)).

3. Dollar limitations for married couples who file a joint return and don't qualify for the $500,000 limitation. In the case of a husband and wife who make a joint return for the year of sale or exchange and who do not meet the requirements for the $500,000 exclusion, the amount of gain eligible for the exclusion is the sum of the amounts to which each spouse would be entitled if the spouses had not been married. For purposes of this rule, each spouse is treated a owning the property during the period that either spouse owned the property (I.R.C. § 121(b)(2)(B), (Treas. Reg. § 1.121-2(b)(2)). Thus, if a married couple filing a joint return does not qualify for the $500,000 maximum exclusion, the amount of the maximum exclusion that may be claimed by the couple is the sum of each spouse's maximum exclusion determined on a separate basis.

L. Reduced Exclusion. Certain taxpayers who fail to meet the ownership requirements or who have sold or exchanged principal residences within two years may qualify for a reduced exclusion. (I.R.C. § 121(c)(2)(A), Treas. Reg. 1.121-3)

1. Sales and exchanges eligible for the reduced exclusion. The reduced exclusion applies to any sale or exchanges if:

a. the exclusion would not (but for these rules relating to the reduced exclusion) apply to the sale or exchange by reason of:

(1) a failure to meet the ownership and use requirements (I.R.C. § 121(c)(2)(A)(i)), *or*

(2) the limit of only one sale every two years (I.R.C. § 121 (c)(2)(A)(ii)), *and*

b. the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances. (I.R.C. § 121(c)(2)(B)), Treas. Reg. § 1.121-3(b)).

2. Whether the reduced exclusion requirements apply depends on all the facts and circumstances. A taxpayer automatically meets the primary reason requirement if he qualifies for a safe harbor carried in the regulations for the above conditions. If he doesn't qualify for a safe harbor, factors that may be relevant in determining his primary reason for the sale or exchange include (but aren't limited to) the extent to which:

a. the sale and the circumstances giving rise to it are close in time;

b. the suitability of the home as the taxpayer's principal residence materially changes;

c. the taxpayer's financial ability to maintain the home materially changes;

d. the taxpayer uses the home as his residence during the period that he owns the property;

e. the circumstances causing the sale are not reasonably foreseeable when he begins using the home as his principal residence; and

f. the circumstances causing the sale occur during the period that the taxpayer owns and uses the home as his principal residence. (Treas. Reg. § 1.121- 3(b)).

3. Change in place of employment safe harbor.

a. A homeseller qualifies for the partial homesale exclusion rule if the primary reason for the sale is a change in the location of a qualified individual's employment. (Treas. Reg. § 1.121-3(c)(1)).

b. A qualified individual is the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. (Treas. Reg. § 1.121-3(f)).

c. Under a safe harbor, the primary reason for a sale is a change in the location of a qualified individual's employment if two conditions are met:

(1) The individual's new place of employment is at least 50 miles farther from the residence sold than the former place of employment was. If the individual doesn't have a former place of employment (i.e., he is just entering the job market), the new place of employment must be at least 50 miles from the residence that is sold.

(2) The change in place of employment occurs while the taxpayer owns and uses the home as his principal residence. (Treas. Reg. § 1.121-3(c)(2)).

d. For purposes of the change-in-employment safe harbor, employment includes the beginning of employment with a new employer, the continuation of employment with the same employer, and the beginning or continuation of self-employment. (Treas. Reg. § 1.121-3(c)(3)).

4. Change in health safe harbor. A taxpayer qualifies for the partial homesale exclusion rule if the primary reason for selling the home is:

a. to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual; or

b. to obtain or provide medical, or personal care for a qualified individual suffering from a disease, illness, or injury. (Treas. Reg. § 1.121-3(d)(1)).

c. For purposes of the health condition, a qualified individual is:

(1) the taxpayer or the taxpayer's spouse;

(2) a co-owner of the residence;

(3) a person whose principal place of abode is in the same household as the taxpayer; or

(4) the taxpayer's family members listed in I.R.C. § l52(a)(1) through I.R.C. § 152(a)(8), even if they aren't his dependents (this includes children or their descendants, siblings and their children, uncles, aunts, parents or their ancestors, stepchildren, stepbrothers, stepsisters, stepparents, and in-laws); and descendants of the taxpayer's grandparent (e.g., first cousins). (Treas. Reg. § 1.121-3(f)

5. Unforeseen circumstances safe harbor.

a. A home is sold for unforeseen circumstances, thereby qualifying the taxpayer for the partial homesale exclusion, if the primary reason for the sale is the occurrence of an event that he did not anticipate before buying and occupying the home. (Treas. Reg. § 1.121-3(e)(1)).

b. Under a safe harbor rule, the primary reason for a homesale is deemed to be unforeseen circumstances if any of the following events occur while the taxpayer owns and uses the home as a principal residence. (Treas. Reg. § 1.121-3(e)(2)). A qualified individual for purposes of the following events is the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. (Treas. Reg. § 1.121-3(f)).

(1) Involuntary conversion of the residence. Under I.R.C. § 1033, an involuntary conversion includes the destruction of property in whole or in part, or its seizure, requisition, or condemnation (or threat or imminence thereof).

(2) A natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence.

Example: In 2003, Abigail buys a house in California. After she begins to use the house as her principal residence, an earthquake damages it. Abigail sells the house at a profit in 2004. She is entitled to the partial homesale exclusion. (Reg. § 1.121-3 (e)(4), Ex. 1)

(3) Death of a qualified individual.

Example: Jack Smith's wife, Edna, dies a year after he bought a home that they used as their principal residence. He sells the residence and moves to Florida. Smith qualifies for the partial homesale exclusion regardless of his actual motives for selling the home. The same result would apply even if Edna had been his long-time companion rather than his wife.

(4) A qualified individual's cessation of employment making him eligible for unemployment compensation.

(5) A qualified individual's change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living).

(6) A qualified individual's divorce or legal separation under a decree of divorce or separate maintenance.

(7) Multiple births resulting from the same pregnancy of a qualified individual. (Treas. Reg. § 1.121-3(e)(2)(E)).

(8) An event determined by IRS to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer. For example, in Notice 2002-60, 2002-36 IRB 482, IRS said that the terrorist attacks of 9/11/01 were unforeseen circumstances for purposes of the partial homesale exclusion rule, if certain conditions were met.

6. Amount of the reduced exclusion. For taxpayers subject to the reduced exclusion, the dollar limitation (either $250,000 for single taxpayers or $500,000 for certain joint filers) is equal to:

a. the amount which bears the same ratio to the dollar limitation ($250,000 or $500,000), (I.R.C. § 121(c)(1)(A)) *as*

b. *the shorter of*: (I.R.C. § 121 (c)(1)(B)(i))

(1) The aggregate periods, during the five year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer’s principal residence, (I.R.C. § 121 (c)(1)(B)(i)(I)) *or*

(2) The period after date of the date of the most recent earlier sale or exchange by the taxpayer to which the exclusion applied and before the date of the sale or exchange (I.R.C. § 121 (c)(1)(B)(i)(II)).

(3) The numerator of the fraction is the shortest of the period of time that the taxpayer owned the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property during the 5-year period ending on the date of the sale or exchange; or the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under *section 121* and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. (Treas. Reg. § 1.121-3(g)(1)).

(4) bears to two years (I.R.C. § 121 (c)(1)(B)(i)(II), I.R.C. § 121(c)(1)). The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator). (Treas. Reg. § 1.121-3(g)(1)).

THE BOTTOM LINE: An otherwise qualifying taxpayer who fails to satisfy the two-year ownership and use requirements is able to exclude an amount equal to a fraction of the $250,000 or $500,000 limitation.

Example. Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in place of her employment. A has not excluded gain under section 121 on a prior sale or exchange of property within the last 2 years. A is eligible to exclude up to $ 125,000 of the gain from the sale of her house (12/24 x $ 250,000). (Treas. Reg. § 1.121-3(g) Example (1)).

Example. Taxpayer H owned a house that he used as his principal residence since 1996. On January 15, 1999, H and W marry and W begins to use H's house as her principal residence. On January 15, 2000, H sells the house due to a change in H's and W's place of employment. Neither H nor W has excluded gain under section 121 on a prior sale or exchange of property within the last 2 years.

(i) Because H and W have not both used the house as their principal residence for at least 2 years during the 5-year period preceding its sale, the maximum dollar limitation amount that may be claimed by H and W will not be $ 500,000, but the sum of each spouse's limitation amount determined on a separate basis as if they had not been married.

(ii) H is eligible to exclude up to $ 250,000 of gain because he meets the requirements of *section 121*. W is not eligible to exclude the maximum dollar limitation amount. Instead, W is eligible to claim a reduced exclusion. Because the sale of the house is due to a change in place of employment, W is eligible to exclude up to $ 125,000 of the gain (365/730 x $ 250,000). Therefore, H and W are eligible to exclude up to $ 375,000 of gain ($ 250,000 + $ 125,000) from the sale of the house. (Treas. Reg. § 1.121-3(g)(2) Example (2)).

M. Application of section 121 to only 1 sale or exchange every 2 years. In general. Except as otherwise provided in section 1.121-3 (relating to the reduced exclusion), a taxpayer may not exclude from gross income gain from the sale or exchange of a principal residence if,

1. During the 2-year period ending on the date of the sale or exchange, the taxpayer sold or exchanged other property for which gain was excluded under section 121.

2. For purposes of this paragraph (c)(1), any sale or exchange before May 7, 1997 is disregarded. (I.R.C. § 121(b)(3)(A)).

3. If a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the previous two years, the newly married taxpayer is allowed a maximum exclusion of $250,000 (H. Rep. No. 105-148).

4. The rule limiting the exclusion to one sale every two years by the taxpayer does not prevent a husband and wife filing a joint return with each excluding up to $250,000 of gain from the sale or exchange or each spouse's principal residence provided that each spouse would be permitted to exclude up to $250,000 of gain if they filed separate returns (Conf. Rep. No. 105-220).

Example. Taxpayer A owned a townhouse that he used as his principal residence for two full years, 1998 and 1999. A then bought a house in 2000 that he owned and used as his principal residence. A sells the townhouse in 2002 and excludes gain realized on its sale under section 121. A sells the house in the next year, 2003. Section 1.121-3 (relating to the reduced exclusion) does not apply to the sale of the house. Although A meets the 2-year ownership and use requirements of section 121, A is not eligible to exclude gain from the sale of the house because A excluded gain within the last 2 years under section 121 from the sale of the townhouse. (Treas. Reg. § 1.121-2(b)(2) Example).

N. Recapture of depreciation. Gain attributable to depreciation taken after May 6, 1997 is not excludable under section 121. (I.R.C. § 121(d)(6)), Treas. Reg. 1.121-1(d)). Covered in greater detail in Sale of Rental Property at Chapter K.

Example. On July 1, 2009, Taxpayer F moves into a house that he owns and had rented to tenants since July 1, 2007. F took depreciation deductions totaling $ 14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, F sells the property on August 1, 2011. F's gain realized from the sale is $ 40,000. F had no capital losses for 2011. Only $26,000 ($ 40,000 gain realized - $ 14,000 depreciation deductions) may be excluded under section 121. The $ 14,000 of gain recognized by F is unrecaptured section 1250 gain within the meaning of section 1(h). (Treas. Reg. § 1.121-1(d)(2) Example)

O. Reporting Gain.

1. If the gain on the sale of a principal residence is entirely excluded under I.R.C. § 121, the transaction generally is not reported on the seller's income tax return (IRS Pub No. 523 (2006) p. 20) unless the home was used for business or income-producing purposes. The real estate reporting person certifies these facts on an information return to the Internal Revenue Service. (I.R.C. § 6045 as amended by the Tax Reform Act of 1997.)

2. The transaction must be reported on the return if there is taxable gain on the home sale.

a. This may occur, for example, if:

(1) Realized gain exceeds the applicable I.R.C. § 121 exclusion,

(2) The seller elected under I.R.C. § 121(f) not to use the homesale exclusion; or

(3) The taxpayer claimed depreciation attributable to post-May 6, '97 periods with respect to the principal residence.

(4) Reporting taxable gain. In general, if there is taxable gain on a home sale, it should be reported as follows:

(a) The entire gain realized is reported on Schedule D (Form 1040), on line 1 (if the home was held one year or less) or line 8 (if the home was held more than one year).

(b) Sellers who qualify for an exclusion show it on the line directly below the line on which they report the gain, write “Section 121 exclusion” in column (a) of that line, and show the amount of the exclusion in column (f) as a loss (in parentheses). (IRS Pub No. 523 (2006) p. 20)

(c) Sellers who must pay tax on gain representing post-May 6, '97 depreciation, or must allocate gain between the dwelling-unit portion of a residence and the non-dwelling-unit portion used for business or rental, report gain on Form 4797. (IRS Pub No. 523 (2006) p. 20).

P. Election out of homesale exclusion.

1. The homesale exclusion automatically applies if the taxpayer meets the conditions for its application.

2. A taxpayer may elect not to have the exclusion apply to a transaction that would otherwise be eligible for it. (I.R.C. § 121(f)).

3. The election is made by filing a return for the year of sale that includes the gain from the sale of the principal residence.

4. The election may be made (or revoked) at any time before the expiration of a 3-year period beginning on the unextended return due date for the year in which the sale occurred. (Treas. Reg. § 1.121-4(g)).

Q. Homesale exclusion's ownership and use tests for taxpayers involved in a divorce.

1. Spouses own the home jointly.

a. If each spouse independently meets the 2-out-of-5-year ownership and use test, and isn't ineligible because of prior use of the exclusion during the two year period ending on the sale date,

b. Then each spouse's share of the homesale profit can be sheltered by the up-to-$250,000 exclusion.

c. The fact that the spouses file separate returns for the year of sale, or are divorced and file as single persons, doesn't make a difference. (Treas. Reg. § 1.121-2(a)(2)).

Example: Hal and Dee Simpson were divorced in June of Year 1. In Sept. of Year 2, they sell the home they owned jointly and used as a principal residence for ten years. The home is sold for $600,000, yielding a gain of $400,000. Each of them can exclude $200,000 of gain from tax. (RIA – Making the Most of the Homesale Exclusion)

2. One spouse owns the home but transfers ownership to the other spouse. A favorable "tacking" rule applies in this situation. Where an individual obtains a home from a spouse or former spouse under a transaction described in I.R.C. § 1041(a), namely a transfer between spouses, or a transfer to a former spouse incident to divorce, the period that the transferee owns the home includes the period that the transferor owned the home. (I.R.C. § 121(d)(3)(A), Treas. Reg. § 1.121-4(b)(1)).

Example: For 20 years Fred and Martha used a home owned by Fred as their principal residence. They divorce this month and under their divorce decree Fred transfers ownership of the home to Martha. Six months later, she sells the home at a $200,000 gain, all of which may be excluded because she meets the two-out-of-five year use test, and also meets the two-out-of-five year ownership test because she can tack on Fred's ownership period to her own.
(RIA – Making the Most of the Homesale Exclusion)

3. One spouse is awarded use of the home, but both still own it. Solely for purposes of the homesale exclusion, a person is treated as using a home as his principal residence during any period of ownership while the person's spouse or former spouse is granted use of the property under a divorce or separation instrument (as defined in I.R.C. § 71 (b)(2)). (I.R.C. § 121(d)(3)(B), Treas. Reg. § 1.121-4(b)(2)).

R. Homesale exclusion ownership-and-use test for surviving spouse.

1. For purposes of the homesale exclusion, if a person's spouse was deceased on the date of the home sale, the period that the surviving spouse owned and used the property as a principal residence includes the period that the deceased spouse owned and used the property as a principal residence before death.

2. This rule applies only if the surviving spouse has not remarried at the time the home is sold. ((I.R.C. § 121(d)(2), Reg. § 1.121-4(a)(1)).

3. Where the two-year ownership and use requirement is actually met (or deemed met) a surviving spouse who files a joint return with the deceased spouse for the year of death, and sells the home that year, would be entitled to exclude up to $500,000 of gain if neither spouse had excluded gain from the sale of a principal residence during the two-year period ending on the date of the sale.

4. Under I.R.C. § 121 (b)(2), the up-to-$500,000 exclusion is available only if husband and wife make a joint return for the year of sale. As a result, if the home is sold in a year after the year of death, the surviving spouse would be entitled to a maximum homesale exclusion of only $250,000. However, regardless of when the home is sold, where the spouses jointly owned the residence, the surviving spouse's basis in the decedent's half of the property is stepped-up to its date-of-death or alternate-valuation-date value.

Example: Husband and Wife have a basis of $100,000 in their jointly owned principal residence which they bought many decades ago. They each contributed equally to the purchase price of the home and the cost of improvements that are reflected in the $100,000 basis. When Husband dies in 2003, the home is valued at $1 million. Wife's basis in the home is $550,000 ($50,000 + $500,000). If she sells the home for $1 million in 2003, all of her $450,000 gain may be excluded. If she sells for $1 million in 2004, only $250,000 of the gain may be excluded. (RIA – Making the Most of the Homesale Exclusion)

VII. UP TO TEN-YEAR SUSPENSION OF HOMESALE EXCLUSION FIVE-YEAR PERIOD FOR QUALIFYING MILITARY OR FOREIGN SERVICE PERSONNEL.

A. (I.R.C § 121(d)(9), as amended by 2003 Military Family Act §101(a), Generally effective: Sales and exchanges of a principal residence after May 6, 1997).

B. I.R.C. § 121(d)(9) Members of uniformed services and foreign service.

(A) In general. At the election of an individual with respect to a property, the running of the 5-year period described in subsections (a) and (c)(1)(B) and paragraph (7) of this subsection with respect to such property shall be suspended during any period that such individual or such individual's spouse is serving on qualified official extended duty

(i) as a member of the uniformed services,

(ii) as a member of the Foreign Service of the United States, or

(iii) as an employee of the intelligence community.

(B) Maximum period of suspension. The 5-year period described in subsection (a) shall not be extended more than 10 years by reason of subparagraph (A).

(C) Qualified official extended duty. For purposes of this paragraph—

(i) In general. The term "qualified official extended duty" means any extended duty while serving at a duty station which is at least 50 miles from such property or while

residing under Government orders in Government quarters.

(ii) Uniformed services. The term "uniformed services" has the meaning given such term by section 101(a)(5) of title 10, United States Code, as in effect on the date of the enactment of this paragraph.

(iii) Foreign Service of the United States. The term "member of the Foreign Service of the United States" has the meaning given the term "member of the Service" by paragraph (1), (2), (3), (4), or (5) of section 103 of the Foreign Service Act of 1980, as in effect on the date of the enactment of this paragraph.

(iv) Employee of intelligence community. The term "employee of the intelligence community" means an employee (as defined by section 2105 of title 5, United States Code) of –

[portions omitted]

(v) Extended duty. The term "extended duty" means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

(D) Special rules relating to election.

(i) Election limited to 1 property at a time. An election under subparagraph (A) with respect to any property may not be made if such an election is in effect with respect to any other property.

(ii) Revocation of election. An election under subparagraph (A) may be revoked at any time.

C. For purposes of determining whether a sale of an individual's principal residence qualifies for the $250,000/$500,000 exclusion, the 2003 Military Family Act provides that, at the election of an individual with respect to a property, the running of the five-year ownership and use period with respect to that property is suspended during any period that the individual or the individual's spouse is serving on *qualified official extended duty* as a member of the *uniformed services* (defined below) or of the *Foreign Service of the U.S.* (I.R.C. § 121(d)(9)(A) as amended and redesignated by 2003 Military Family Act §101(a)).

1. The five-year period can't be extended by more than ten years. (I.R.C. § 121(d)(9)(B)). Thus, an individual may elect to suspend for a maximum of ten years the five-year test period for ownership and use of a principal residence during certain absences due to service in the uniformed services or the U.S. Foreign Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does *not* include any period up to ten years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or the U.S. Foreign Service. (Committee Report for JCX-99-03, HR3365)

Example 1: C, a Navy officer, buys a residence in Florida on July 1, Year 1, and uses it as his principal residence until June 30, Year 2. On July 1, Year 2, C goes on qualified official extended duty in Japan until June 30, Year 8. At the end of this period, C returns to his Florida residence and uses it as his principal residence until July 30, Year 9.

If C has made the election to suspend the five-year period and sells the residence on July 30, Year 9, the five-year period, for purposes of determining whether C is eligible for the exclusion, won't include the six years of his qualified official extended duty (i.e., from July 1, Year 2 until June 30, Year 8). Thus, C is eligible to claim an exclusion up to $250,000 because he used the residence for at least two years (from July 1, Year 1 until June 30, Year 2 and from July 1, Year 8 until July 30, Year 9) in the relevant five-year period. (RIA Analysis of the Military Family Tax Act of 2003).

Example 2: The facts are the same as in illustration (1) except that C goes on qualified official extended duty until June 30, Year 14. On July 1, Year 14, C returns to his Florida residence and uses it as his principal residence until he sells the residence on July 2, Year 15.

The maximum period of time that the five-year period can be suspended is ten years (i.e., until June 30, Year 12). The five-year period (as suspended) for determining whether C is entitled to the exclusion includes:

... July 1, Year 1 to June 30, Year 2, and
... July 1, Year 12 to July 2, Year 15.

During that period, C owned and used the residence as his principal residence from July 1, Year 1 to July 1, Year 2 (one year) and from July 1, Year 14 until July 2, Year 15 (one year and a day). Thus, any gain from the sale of C's principal residence is eligible for the up to $250,000 exclusion. (RIA Analysis of the Military Family Tax Act of 2003).

2. I.R.C. § 121(d)(9) doesn't specify how and when to make or revoke the election. Presumably, IRS will provide guidance on how and when to make the election.

3. Election limited to one property at a time.

   a. The election with respect to any property (i.e., principal residence) may not be made if an election is in effect with respect to any other property. (I.R.C. § 121(d)(9)(D)(i))

   b. The election may be made with respect to only one property for a suspension period. (Com Rept.)

   c. An election may be revoked at any time. (I.R.C. § 121(d)(9)(D)(ii)).

   d. The language in I.R.C. § 121(d)(9)(D)(i) restricting the ability of an individual to make an election if an election "is in effect" implies that the individual has to make the election before the sale of the residence.

   e. Presumably, IRS will provide guidance on when an individual has to make the election.

4. Definitions.

   a. *Qualified official extended duty.*

      (1) For purposes of the suspension rule described above (I.R.C. § 121(d)(9)(C)), *qualified official extended duty* is any extended duty (defined below) while serving at a duty station which is at least 50 miles from the property or

      (2) While residing under Government orders in Government quarters. (I.R.C. § 121(d)(9)(C)(i))

(3) In other words, qualified official extended duty is any period of extended duty by a member of the uniformed services, or the U.S. Foreign Service while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. (Com Rept.)

b. *Extended duty.*

(1) For purposes of the suspension rule, *extended duty* is any period of active duty under a call or order to active duty for a period of more than 90 days or for an indefinite period. (I.R.C. § 121(d)(9)(C)(iv))

(2) This definition of “extended duty” is the same as the definition of “extended active duty” that applied to special rules relating to the application of the rollover rules to members of the armed forces for sales and exchanges before May 7, '97. Thus, regs relating to those pre-May 7, '97 transactions (Reg §1.1034-1(g)(5)), may provide guidance in interpreting the definition of extended duty.

c. *Uniformed services.*

(1) For purposes of the suspension rule, *uniformed services* has the meaning given that term by 10 USCS 101(a)(5), as in effect on Nov. 11, 2003. (I.R.C. § 121(d)(9)(C)(ii)) Thus, uniformed services include the:

(a) Armed forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard);

(b) Commissioned corps of the National Oceanic and Atmospheric Administration; and

(c) Commissioned corps of the Public Health Service. (Com Rept.).

(d) Although this definition of uniformed services doesn't expressly include the Army National Guard or the Air National Guard, presumably individuals serving in those services are included in this definition. For example, 10 USCS 101(c)(3) defines the “Army National Guard” as the reserve component of the Army all of whose members are members of the Army National Guard. Similarly, 10 USCS 101(c)(5) defines the “Air National Guard” as the reserve component of the Air Force, all of whose members are members of the Air National Guard.

(e) Presumably, civilians working for the armed forces are not members of the armed forces for purposes of the suspension provision.

5. How the suspension affects the reduced exclusion.

a. The up to ten-year suspension also applies to the five-year period that applies for determining the amount of a reduced exclusion under I.R.C. § 121(c)(1)(B), (I.R.C. § 121(d)(9)(A)).

b. A sale of an individual's principal residence would still have to meet the requirements for the reduced exclusion (i.e., the sale is by reason of a change of place of employment, health, or unforeseen circumstances).

c. In most cases, a sale of a principal residence by an individual on *qualified official extended duty* (defined above) presumably would be considered a sale by reason of a change in place of employment and thus qualify for the reduced exclusion.

Example: D, a single member of the Marine Corps, buys a residence in California on Jan. 1, Year 1, and uses it as his principal residence until Dec. 31, Year 1. On Jan, 1, Year 2, D goes on qualified official extended duty in Europe until Dec. 31, Year 8. While on qualified official extended duty, D sells his California residence for a gain of $300,000 on Jan. 2, Year 8. The sale of D's California residence otherwise qualifies for a reduced exclusion as a sale by reason of a change in D's place of employment.

If D has elected to suspend the five-year period and otherwise qualifies for the reduced exclusion, D is eligible to exclude up to $125,000 of his gain (12/24 × $250,000) because during the relevant period, D owned and used the residence as a principal residence for one year (or twelve months).

Example: The facts are the same as in the illustration above except that D is on qualified official extended duty from Jan. 1, Year 2 until Dec. 31, Year 13. After his qualified official extended duty, D doesn't live in the California residence. D sells the California residence on Dec. 31, Year 15.

Under I.R.C. § 121(d)(9)(B) (see above), the maximum period of time that the five-year period can be suspended is ten years (i.e., until Dec. 31, Year 11). The five-year period (as suspended) for determining whether D is entitled to a reduced exclusion includes:

... Jan. 1, Year 1 to Dec. 31, Year 1, and
... Jan. 1, Year 12 to Dec. 31, Year 15.

D is eligible to exclude up to $125,000 of his gain (12/24 × $250,000) because during the relevant five-year period, D owned and used the residence as a principal residence for one year (or twelve months).

PART B – RENTAL PROPERTY

VIII. INTRODUCTION.

Military taxpayers who rent houses report and net rental income and rental deductions/depreciation on Form 1040, Schedule E. Rental expenses may offset rental income and other income (e.g., salary, interest, and dividends) when the taxpayer performs some management role. In that case, the taxpayer-landlord may be able to deduct up to $25,000 of real estate rental losses from other income (taxpayer's AGI must be less than $100,000).

IX. RENTAL INCOME. (I.R.C. § 61(a)(5))

A. Rental Income Is Included In Gross Income.

1. Rent is a payment received (or constructively received) for the use and occupancy of property.

2. Rental income includes advance payments of rent (amount received before the period it covers).

3. If a security deposit is to be used as the last month's rent, it is included as rental income in the year paid. If the landlord intends to return it to the tenant at the end of the lease, it is not included as income. Generally, security deposits are not considered rent.

4. Insurance proceeds for loss of rental income because of fire or other casualty are income.

5. Payments by the tenant for canceling or modifying the lease are considered rental income when received.

6. Rental income also includes expenses paid by a tenant (Treas. Reg. § 1.61-8(c)). Improvements made by a tenant are not income.

7. If property or services are received as rent instead of cash, include the fair market value of the property or services as rental income.

B. Reporting Rental Income (Schedule E, Part I, line 3).

1. Rental income is reported by cash basis taxpayers when received and by accrual basis taxpayers when due unless the rent is considered uncollectible.

2. All rental income must be reported on Schedule E.

3. If more than three rental properties, attach additional Schedule Es.

4. Use Schedule E, Parts II - IV, to report income from estates, partnerships, S Corporations, trusts, and real estate mortgage investment conduits.

X. RENTAL EXPENSES (I.R.C. § 62(a)(4); Treas. Reg. § 1.62(c)(8)).

A. General Rule: Deduct rental expenses in the year paid or incurred.

B. Types of Rental Expenses.

1. Advertising (Schedule E, line 5).

2. Automobile and travel expenses to check on the property (Schedule E, line 6).

a. "Ordinary and necessary costs" incurred to collect rental income or to manage, conserve, or maintain the rental property.

b. Includes actual costs of car, air, train, and bus fares.

c. Instead of computing actual expenses, a taxpayer may deduct a standard mileage rate.

3. Cleaning and maintenance expenses (Schedule E, line 7).

4. Commissions paid to find tenants (Schedule E, line 8).

5. Insurance (Schedule E, line 9).

6. Legal and professional fees (Schedule E, line 10).

7. Management fees (Schedule E, line 11).

8. Mortgage interest paid to banks, etc. (Schedule E, line 12). Points paid on rental property must be prorated over the mortgage term (*Moore v. Commissioner*, T.C. Memo. 1994-503).

9. Other interest (Schedule E, line 13).

10. Repairs (Schedule E, line 14).

    a. Repairs are expenses to keep the property in good working order and are not capital improvements (e.g., repainting, fixing gutters or floors, plastering, replacing broken windows).

    b. Improvements are not deductible but must be added to the capital account and depreciated.

        (1) Improvements add to the value of the property, prolong its useful life, or adapt it to new uses.

Examples of improvements: finishing a basement, paneling a room, adding a bathroom or other addition, rewiring or replumbing the house, paving the driveway, and putting on a new roof.

However, Owners of rental property can expense the cost of a new roof. After a tenant complained about damage to the unit caused by a roof leak, the landlord paid a contractor $8,000 to remove and resurface the roof.
The re-roofing is a deductible repair, the Tax Court decides. No structural changes were made to the roof, which was merely restored to its previous leak-free condition (Campbell, TC Summ. Op. 2002-117).

        (2) Add the cost of improvements made before the property is rented to the basis of the property.

    c. Repairs may constitute improvements when they are undertaken as part of an extensive renovation plan.

11. Supplies (Schedule E, line 15).

12. Taxes (Schedule E, line 16).

13. Utilities and fees for services provided tenants (Schedule E, line 17).

14. Other. Ordinary and necessary expenses. I.R.C. § 162.

C. Dividing Expense Deductions Between Personal and Rental Use.

1. If part of a dwelling is rented, the expenses must be prorated between the personal expenses and the rental expenses. Expenses which only relate to the rental activity need not be prorated.

   a. Any reasonable method of prorating expenses may be used.

   b. Some of the personal expenses (interest and taxes) may still be deductible as an itemized deduction on Schedule A.

2. If the property is converted during the tax year to rental (or back to personal) use, allocate the expenses based on the number of months used for rental purposes.

D. Vacation Properties (I.R.C. § 280A).

1. If a taxpayer uses a dwelling unit as a residence, limits apply to the deductions that can be claimed.

2. To constitute use as a residence, the property must be subject to personal use for a period of more than 14 days or 10 percent of the period the property is actually rented out, whichever is greater.

3. Personal use includes use by anyone who has an interest in the property or their family members, unless fair market rental is paid.

   a. Any use for less than fair rental value is personal use.

   b. Use by one who permits the owner to use another property is personal use.

   c. Shared equity arrangements are an exception to the personal use rules.

4. Exceptions to the limitations.

   a. If the property is rented for fewer than 15 days, and is used as a residence, none of the rental expenses are deductible on Schedule E. All interest, taxes, and casualty losses will be deductible, if at all, as itemized deductions on Schedule A. However, neither is the rent included in gross income. (I.R.C. § 280A(g)).

b. If the property is used as a principal residence, either before or after the rental period, the days occupied as a primary residence may not be counted as personal use.

5. If the taxpayer has used the dwelling unit and rented it, the expenses must be divided between rental use (Schedule E) and personal use (Schedule A).

6. Limitations on deductions (Schedule E). If property has been used as a residence during the rental period, the taxpayer can only deduct rental expenses in the following order:

a. Interest, taxes, and casualty losses that are allocable to the rental use (these expenses are always deductible in full).

b. Operating and maintenance expenses, other than depreciation, are next deducted, but only to the extent that rental income exceeds the deductions in item a., above.

c. Depreciation deductions are allowed only to the extent that rental income exceeds the deductions in items a. and b., above.

NOTE: These ordering rules apply only to dual use property, i.e., property used alternatively for personal and rental use. This does not apply to property fully converted from personal to rental use.

XI. DEPRECIATION (see IRS Pub. 527, Residential Rental Property & IRS Pub 946, How to Depreciate Property).

A. Determining Depreciation. How much depreciation can be deducted is determined mainly by:

1. Basis in the property; and

2. Recovery period for the property.

B. What Can Be Depreciated?

1. Real property other than land.

2. Personal property.

3. Property that meets all three of the following conditions:

a. Used in business or held for the production of income;

b. Has a determinable useful life longer than one year; and

c. Is something that wears out, gets used up, decays, becomes obsolete, or loses value from natural causes.

C. Basis for Depreciation.

1. The basis of property held for rent is generally its cost, minus the value of land.

2. If property originally used for personal use is converted, basis is the lower of adjusted basis or fair market value on the date of conversion.

3. Depreciation will be disallowed if basis cannot be proved.

4. Total depreciation claimed must not exceed the depreciable basis of the property.

5. Deducting depreciation is not an election: allowable depreciation not deducted is lost and will reduce the basis at time of sale. (I.R.C. § 1016(a)(2)).

D. Methods of Depreciation.

1. Property placed in service before 1981 could be depreciated under several methods.

a. Straight line.

b. Declining balance method.

2. Property "placed in service" after 1980, but before 1987, must be depreciated using the Accelerated Cost Recovery System (ACRS).

a. If taxpayer used the property (or a relative owned it) before 1981, and converted it to rental property after 1980, the ACRS system cannot be used.

b. ACRS allows rapid recovery of an asset cost using fixed recovery schedules over prescribed periods.

(1) No need to estimate useful life.

(2) Salvage value need not be estimated.

c. Recovery periods for property placed in service before 1987:

(1) 3-Year Property: Includes personal property with a midpoint class life of 4 years or less (automobiles, light trucks).

(2) 5-Year Property: Personal property that is not 3-, 10-, or 15-year property (includes most office equipment like computers, as well as office furniture).

(3) 15-year property: Real property placed in service between December 31, 1980 and March 16, 1984.

(4) 18-Year Property: Real property placed in service after March 15, 1984 and before May 9, 1985.

(5) 19-Year Property: Real property placed in service after May 8, 1985, but before 1 January 1987. Those who place real property in service after 31 July 1986 may elect a modified ACRS under the Tax Reform Act of 1986.

3. Modified Accelerated Cost Recovery System (MACRS) I.R.C. § 168 (see Appendix B, Figuring MACRS Depreciation).

a. The Tax Reform Act of 1986 modified the ACRS system for all property "placed in service" after 31 December 1986.

(1) Property used as a home prior to 1986 and converted after 1986 must be depreciated under MACRS.

(2) Taxpayers may elect to have a modified ACRS system apply to property placed in service after 31 July 1986 but before 31 December 1986.

b. MACRS provides two systems for depreciating property.

(1) General Depreciation System. GDS property is assigned a certain recovery period (i.e., 3, 5, or 7 years) and uses two methods of depreciation--declining balance (accelerated depreciation) and straight line (constant depreciation).

(2) Alternative Depreciation System. ADS property is assigned a certain recovery period (usually longer than the GDS method) and is depreciated using the straight-line method. A taxpayer may elect to use this method.

c. To figure the MACRS deduction, the taxpayer must know the following about the property:

(1) Its recovery period (and the applicable convention);

(2) Its placed-in-service date; and

(3) Its depreciable basis.

d. Recovery Periods Under MACRS.

(1) The 3-, 5-, 10-, and 15-year recovery classes under ACRS are retained. Cars are shifted from 3- to 5-year class.

(2) Nonresidential real property. This class includes any real property with a class life of 27.5 years or more that is not residential rental property. This property is depreciated over 39 years.

(3) Residential real property. This class includes any real property that is a rental building or structure for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If any part of the building or structure is occupied by the taxpayer, the gross rental income includes the fair rental value of the part the taxpayer occupies.

(a) This property is depreciated over 27.5 years under the GDS method.

(b) This property is depreciated over 40 years using the ADS method.

e. Residential and nonresidential property must be depreciated using the straight-line method.

f. All residential real property placed in service is treated as placed in service on the midpoint of that month (mid-month convention). All other property is treated as being placed in service in the middle of the year.

g. Depreciation can begin when the property is placed in service. "Placed in service" for a rental property means when the property is ready and available for a specific use in that activity.

4. The depreciation deduction for each year of the recovery period is figured by applying a certain depreciation method (e.g. straight line or declining balance) to the property's adjusted basis. The taxpayer can calculate this manually or use tables provided by the IRS (see IRS Pub. 946, How to Depreciate Property, Percentage Tables).

a. The adjusted basis does not include the value of land.

b. The percentage of depreciation used each year varies with the property's recovery period and the method of depreciation used (e.g., straight line or declining balance). In the first year, the percentage also varies with the applicable convention (e.g., mid-month or half-year).

c. The percentages in the tables are applied to the adjusted basis of the property each year of the recovery period.

(1) For the purpose of computing the annual deduction, the taxpayer does not reduce the adjusted basis by the amount of depreciation taken in prior years.

(2) For the purpose of computing gain or loss on the sale of the property, the taxpayer must reduce the adjusted basis by the amount of depreciation taken in prior years.

5. Depreciation deduction for improvements.

   a. The period for computing depreciation begins on the date in which the addition or improvement is placed in service.

   b. Example. Colonel Jones owns rental property in Washington, D.C. and has been depreciating the property since 1984 under ACRS. In 2006, he adds an addition. He must depreciate the addition under the MACRS system (residential real property class).

6. If the property is disposed of before being completely depreciated, depreciation for the final year can only be taken for the number of months in service during the year of sale.

7. Figure depreciation on Form 4562, and transfer the result to the appropriate form, normally Schedule E, line 18 (or Schedule C if a business). Refer to IRS Pub. 534, Depreciation for guidance. A taxpayer need not complete Form 4562 if the only depreciation claimed is for property placed in service prior to the current tax year--enter this depreciation directly on Schedule E.

XII. PASSIVE LOSS LIMITATIONS (I.R.C. § 469).

A. General Rules.

1. Individuals cannot offset income, other than income from passive activities, with losses from passive activities.

2. A passive activity is any activity involving the conduct of any trade or business in which the taxpayer does not materially participate.

   a. Material participation requires regular, continuous, and substantial involvement.

   b. Passive activities include most limited partnerships and all rental activities regardless of material participation.

3. Net passive activity losses and passive activity credits are disallowed but may be carried forward to next tax year. All passive activity losses (not credits) that have accumulated will be allowed in year property is disposed (I.R.C. § 469(g)).

B. Losses From Rental Real Estate.

1. A special rule allows a $25,000 offset of nonpassive income ($12,500 for married couples who lived apart for the entire year filing separately) for rental real estate activity losses.

2. To constitute non-passive income, the taxpayer must "actively participate" in the rental activity.

   a. Not the same standard as material participation.

   b. Satisfied if taxpayer participates in significant and bona fide sense, e.g., approves lease terms, tenants, and repair decisions.

3. Ownership limitation: taxpayer must own at least a 10% interest.

4. Taxpayer must have a modified Adjusted Gross Income (AGI) less than $150,000. The special $25,000 offset is phased out by 50% of the amount that modified AGI exceeds $100,000. No loss is allowed when the modified AGI exceeds $150,000.

If modified AGI is--	Loss allowance limit is--
Up to $100,000	$25,000
110,000	20,000
120,000	15,000
130,000	10,000
140,000	5,000
150,000 or more	0

5. Passive activity losses and credits are computed on Form 8582, Passive Activity Loss Limitations. Taxpayers do not have to complete and file Form 8582 if:

   a. Losses are only from rental activities.

   b. There are no credits with the rental activities.

   c. Taxpayer actively participated in the rental activity.

   d. There are no losses or credits from any other passive activity.

e. Total losses from rental real estate activity are less than $25,000.

f. Modified adjusted gross income is less than $100,000.

g. Taxpayer lived apart from spouse for entire tax year if married filing separate returns are filed.

6. Enter the amount of deductible real estate loss on Schedule E, line 23.

C. At-Risk Rules.

1. The at-risk rules have been extended to the holders of real estate placed in service after 1986.

2. Under these rules, any loss from an activity is allowed only to the extent of the total amount a taxpayer has at risk in the property (e.g., to the extent of the adjusted basis).

XIII. CONCLUSION

APPENDIX A

INCLUDIBLE ADJUSTMENTS TO TAX BASIS OF PERSONAL RESIDENCE

INSIDE ADDITIONS & IMPROVEMENTS

Accessories & equipment:
Bathrooms-
- Bathtub sliding doors
- Medicine cabinet
- Mirrors
- Shower cabinet
- Shower controls
- Towel racks
- Tub
- Tub hanger
- Unit heater

Kitchen-
- Counter tops
- Dishwasher
- Drainboards
- Food freezer
- Garbage disposal
- Range
- Range hood
- Refrigerator
- Sinks
- Ventilator

Laundry-
- Dryer
- Hot plate for boiling clothes
- Linen chute
- Sink
- Sorting counter
- Supply cabinets
- Tubs
- Ventilator
- Washing machine

Acquisition costs
Appraisal fees
Broker's commission
Closing costs
Legal fees
Recording of deed/mortgage
Survey costs
Title search & insurance
Bookcases & other built-in furniture
Cabinets, closet shelves, etc.
Carpeting and padding
Ceilings (acoustical)
Closets
Communication:
- Call bells or chimes
- Fire or burglar alarm system
- Intercommunication system

Conversion of basement or attic into living space
Cupboards
Fireplace mantel
Flooring-wood, tile, etc.
Inside walls:
- Altering and plastering
- Wall tiles
- Wood paneling

Insulation:
- Ceilings
- Floors
- Pipe and duct
- Roof
- Walls

Linoleum
Mechanical equipment:
- Electricity & lighting-
  - Circuit breakers
  - Fuse boxes
  - Lightning rods
  - TV antenna and wiring
- Hardware, fixtures & locks-
  - For cabinets & closets
  - For curtains and drapes
  - For doors
  - For windows
  - Lighting fixtures
- Heating & air conditioning-

- Air conditioning
- Attic fan
- Boiler
- Circulating system
- Cooling equipment
- Fireplace heater
- Furnace
- Hot water heater
- Radiators & valves
- Hot water tank
- Pumps
- Septic system
- Sump pump
- Traps
- Vent pipe
- Water supply system

Miscellaneous items-
- Dumbwaiter
- Garbage disposal

Other equipment-
- Fireplace equipment
- Mirrors
- Workshop equipment
- Space heater
- Warm air grills/registers

Plumbing and sanitation-
- Cold water pipe
- Copper tubing
- Floor drains
- Grease traps
- Hot water pipe

Radiator covers

Replacement or addition to stairs

Room dividers/partitions

Ventilators

Window seats

Windows:
- Mini-blinds
- Replacement screens
- Storm sash
- Venetian blinds
- Weather Stripping
- Window shades

OUTSIDE ADDITIONS & IMPROVEMENTS

Additional acreage or lots
Additions to buildings:
  Aluminum siding
  Breezeway
  Garage
  Porch
  Wings
  Work shed or other outside buildings
Barbecue pit
Bird bath
Cement staircase
Clothes dryers
Driveway:
  Blacktopping/paving
  Gravel
Electrical outlets
Fences and gates
Garden and grounds:
  Fertilizers & conditioners
  Grading
  Grass seed
  Lawn sprinkler system
  Plants, bulbs, seed
  Rototill soil
  Shrubs, bushes, vines
  Topsoil and fill
  Trees
  Trellis
  Water well and pump
Gutters, leaders, drainpipes and dry wells
Lamppost
Mailbox
Pathways
Play yard
Retaining walls
Roofing additions or replacements
Screens and screen doors
Septic tank or cesspool
Sewers and connection
Storm doors
Surveying of property
Swimming pool
Telephone outlets
Termite proofing
Terraces and patios
Walks
Waste-collecting & burning equip
Waterproofing

APPENDIX B

Figuring MACRS Depreciation

The Residential Rental Property (27.5-year) Table below gives the percentages for rental residential real property placed in service after 1986. It provides the percentage for the year placed in service, years of ownership and the disposed of.

To use the table, find the month that the property was placed in service or disposed of. To determine the depreciation deduction, multiply the percentage listed for that month by the depreciable basis. Special rules govern the use of the table (e.g., the rates must be applied to the taxpayer's unadjusted basis; for more information, see IRS Publication 946, How to Depreciate Property).

Example: T purchased a single-family rental house and placed it in service on 1 February. T's basis in the house was $80,000. Using the percentage from the second column, year 1 column of the table, T computes her depreciation deduction by multiplying $80,000 by .03182 ($2,546).

Residential Rental Property
Method: Straight Line
Convention: Mid - Month
Recovery Period: 27.5-year

The month in the 1st recovery year the property is placed in service.

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	.758	.455	.152
2 – 9, 11, 13	3.636%											
10, 12, 14	3.637%											

Additions or Improvements to Property

Figure the depreciation deduction for any additions or improvements to any property as if the property was placed in service at the same time the addition or improvement was made. Improvements or additions added to residential rental property are depreciated using the same table. Keep a separate deprecation schedule for each improvement or addition. Use the column for the month of taxable year the improvement or addition was completed.

Reporting Depreciation

Taxpayer, who reports rental income on Schedule E, must use Form 4562 for property placed in service in the current year. If the taxpayer placed all depreciable property in service before the current tax year, the taxpayer enters depreciation deduction directly on Schedule E. If taxpayer incurred a rental loss, taxpayer's deduction for depreciation and other expenses may have to be included on Form 8582 to determine net passive activity income or loss.

Depreciation In The Year Of Disposition

From Pub. 946.

If the taxpayer disposes of residential rental or nonresidential real property, base the depreciation deduction for the year of disposition on the number of months in the year of disposal that the property was in service. Under the mid-month convention, treat property disposed of anytime during a month as disposed of in the middle of that month. Count the month of disposition as half a month of service.

Determine the amount of depreciation to claim by determining the depreciation for the year and then multiplying by a fraction. The numerator of the fraction is the number of months (including partial months) in the year that the property is considered in service. The denominator is 12.

Example. On July 2, Current year minus one, the taxpayer purchased and placed in service residential rental property. The property cost $100,000, not including the cost of land. He files his tax return based on the calendar year. He calculated deprecation using the MACRS depreciation tables. He sold the property on March 2, Current year. The depreciation for the current full tax year is $3,636. This is $100,000 multiplied by .03636 (the percentage for years 2 through 9 from the MACRS depreciation table). Then apply the mid-month convention for the 2 1/2 months of use in 2000. Multiply $3,636 by 2.5 and divide by 12 to get the 2000 depreciation deduction of $757.50.

From instructions to Form 4562.

Determine the deprecation rate as follows:

1. For Straight-Line depreciation (residential rental property), divide 1.00 by the remaining number of years in the recovery period as the beginning of the years of disposition (but not less than one). For example if there are 6 ½ years remaining in the recovery period as the beginning of the year of disposition, divide 1.00 by 6.5 for a rate of 15.38%.

2. Multiply the percentage rate determined in Step 1 by the property's unrecovered basis (basis for depreciation (as defined in column (c) of Part II of Form 4562) reduced by all prior year's depreciation).

3. Multiply the result from step 2 by the applicable decimal for the table below.

Month Placed In Service

Month	**1st**	**2nd**	**3rd**	**4th**	**5th**	**6th**	**7th**	**8th**	**9th**	**10th**	**11th**	**12th**
Percentage	**0.0417**	**0.1250**	**0.2083**	**0.2917**	**0.3750**	**0.4583**	**0.5417**	**0.6250**	**0.7083**	**0.7917**	**0.8750**	**0.9583**

Example. On July 2, Current Year minus 2, the taxpayer purchased and placed in service residential rental property. The property cost $100,000, not including the cost of land. He files his tax return based on the calendar year. He calculated deprecation using the MACRS depreciation tables. He sold the property on March 2, 2000.

In current year minus 2, the taxpayer takes $1,667 in depreciation. This is determined by multiply the $100,000 depreciable basis by 1.667% factor taken from the MACRS depreciation table.

In current year minus 1, the taxpayer takes $3,636 in depreciation. This is determined by multiply the $100,000 depreciable basis by 1.667% factor taken from the MACRS depreciation table.

In current year, the taxpayer takes $773.20 in depreciation calculated as follows:

First: Divide 1.00 by the remaining years in the recovery period as the beginning of the years of disposition. At the beginning of 2000, the taxpayer had depreciated the property for 2 years and, therefore, had 25.5 years of his 27.5-year recovery period remaining. For this example, divide 1.00 by 25.5 for a rate of 3.92%.

Second: Multiply the percentage rate determined in Step 1 (3.92%) by the property's unrecovered basis. This is the basis for depreciation reduced by all prior year's depreciation. The taxpayer's depreciable basis is $100,000. Through deprecation, he recovered $1,667 of this basis in 1998 and another $3,636 in 1999, for a total of $5,303. Reduce the depreciable basis of $100,000 by $5,303 to $94,697 and multiply this 3.92% for a sum $3,712.

Third: Multiply by the factor provided in the above table for the month of disposition – March - $3,712 X 0.2083 = $773.20

Alternate Suggestion.

Turn to the MACRS depreciation table for the year the property is placed in service. Remember this table applies the Mid-Month convention to the number of months that the property is used for rental property in the year it is placed in service. Use the table in reverse. If the property is sold in March, it was used as rental property for 3-months under the Mid-Month convention. This is equivalent to placing the property in service in October. Find the multiple for October – 0.758% - and multiply this by the depreciable basis.

Example. On July 2, current year minus two, the taxpayer purchased and placed in service residential rental property. The property cost $100,000, not including the cost of land. He files his tax return based on the calendar year. He calculated deprecation using the MACRS depreciation tables. He sold the property on March 2, current year. For the current year, multiply the $100,000 multiplied by 0.758% (the percentage for October in the year the property is placed in service). This results in $758 depreciation for the year of disposition.

Observation. All three methods produce approximately the same depreciation for the property in the years of disposition. The first method 1 (Pub 946) and the third method (Alternate Suggestion) produce the same result. The second result (Instructions to Form 4562) is the most complex and most closely approximates the code. You may use whichever of these methods you choose.

APPENDIX C

Understanding

Your

Settlement Statement

Part 1 in the series: Buying Your Home
By Keith D. Hempstead, Attorney At Law

Note: The author is a U.S. Army Reserve Judge Advocate. He has posted this brochure to the JAGCNet.

The settlement statement is one of the first documents you will encounter at a real estate closing ceremony for either the purchase of a home or the refinance of a mortgage. It is arguably the most complicated document of the closing and the 45 minutes of an average closing, in which the borrower will sign this document and dozens of others, is not enough time to thoroughly acquaint yourself with its particulars. This booklet will demystify the settlement statement. It is meant as a guide that can be consulted when you preview or review your settlement statement or to prepare you for what to expect when you go to a closing.

The settlement statement, henceforth called the HUD-1, is a two-page document. The page that is of most concern to borrowers and sellers is the first page, marked A on the top left hand corner. This page explains how much money the borrower will have to bring to the closing and how much money the seller will receive after all of his expenses are paid for. These dollar amounts are listed on lines 303 and 603, respectively. To get to these amounts requires that the reader start on the second page of the document marked L on the top left hand corner. The first thing that you will notice is that the second page has two columns. The outer column includes costs that are expenses or charges to be paid by the seller. If the transaction is a refinance then this column will not be used. The inner column includes costs that are expenses or charges to be paid by the buyer. On occasion expenses are paid before the closing but must still be reflected on the settlement statement. For these items the acronym "POC" (paid outside of closing) is used. The attorney or settlement agent who prepared the HUD-1 must list the cost of the service that is POC outside and to the left of the columns. On other occasions, as stipulated by the "offer to purchase contract" or some other agreement, charges will be split between the buyer and the seller. For example, the buyer and seller may agree to split the cost of the appraisal, Line 803. The buyer's column may be charged $150.00, while the seller's column may be charged $200.00. The settlement agent/closing attorney will be responsible for paying the appraiser the full amount he is due.

Throughout this pamphlet we will assume that the HUD-1 is being used for the purchase of a home.

The 700 Section - Real Estate Broker Commissions

This is a seller expense usually. The real estate broker or agent earns his income by charging a commission, based upon the sales price of the home. Standard commissions are 5% to 6% in North Carolina. It varies according to the locality and your particular situation.

Line 700 must list the sales price and the percentage commission. These figures will determine the commission amount on lines 701 and 702. Line 701 will be the commission for the listing agent. If there is only one broker involved then Line 701 will list the full commission and the name of the broker's agency; Line 702 will be blank. If the borrower is represented by a broker then the commission is usually split and the borrower's broker commission will be on Line 702. Make sure that the commissions go to an agency and not the individual agent unless he is working as owner of his own agency. Line 703 will be the first dollar amount listed in the columns labeled as "Paid from Seller's Funds at Settlement". Even though the borrower will be represented by her own agent this commission is traditionally still paid by the seller.

Prior to the closing you more than likely wrote a check for an earnest money deposit to show good faith. This deposit was kept by the listing agent or the closing agent/closing attorney. These funds must be accounted for on the HUD-1 and are listed on Line 704 if the funds were retained by the listing agent. In this common scenario the listing agent will keep the money and have this amount netted from the check for his real estate commission listed on Line 701. On other occasions the listing agent will bring the check to the closing and the closing agent/closing attorney will simply list it as part of the funds brought to the closing by the borrower. If the closing agent/closing attorney kept the funds in an escrow account, then she will count the funds as part of those required by the borrower to complete the closing.

The 800 Section - Lender Fees

Consult with your accountant or tax preparer about some of these 800 series entries. You will be pleasantly surprised to know that some of these amounts are tax deductible, a reason to keep a copy of your HUD-1 and other important closing papers in your permanent files.

Line 801 is for Loan origination fee. This is a one-time setup fee charged by the lender. It is a percentage of the loan i.e. a $150,000 loan might have a loan origination fee of $1,500.00 or one percent. Most loans have loan origination fees that are at one percent or lower. You will find higher percentages in instances where people find it harder to qualify for a loan. You will sometimes hear this fee referred to as points.

Line 802 is Loan Discount. These too are points and are a percentage of the loan. These are sometimes paid in order to gain a lower interest rate or qualify for a loan. This column is not always used, but Line 801 will almost certainly be used in every closing. Points are generally fully deductible on your federal tax return in the year you paid them (or even when the seller agrees to pay them) when buying your principal home. On a loan on a second home, or a home equity loan, the points must be amortized over the life of the loan.

Line 803 covers the cost of the appraisal of the property you are purchasing. An appraisal is an opinion of value rendered by an expert who compares the property to similar properties in the community. If a copy of the appraisal is not presented to you during the closing you have a right to demand a copy of it, after all you paid for it!

Line 804, Credit report, is the cost of the lender ordering a credit history of the borrower. The history is based upon your past experiences in paying installment loans. It is essential to getting loan approval. Increasingly, lenders are using more than the standard credit report that consumers often order from major credit reporting companies such as Experian, Equifax and TransUnion. Lenders use reports that have credit averages that based upon their criteria will determine whether they will lend money and how much. The credit averages contain information on how many times a borrower has been late in making payments and by how many days. Have your lender explain this to you in more detail.

Line 805. Especially in the event of new construction a lender will not release funds to the borrower to complete an additional stage of the home construction until the structure has passed certain structural inspections. Sometimes the inspection is done by a loan officer.

Line 806. Mortgage insurance is a premium that is paid by the borrower but only serves to protect the lender in the event the borrower defaults on the loan. Independent companies issue mortgage insurance policies. The existence of the policy assures the lender that it will not lose on its investment and encourages the lender to lend more money to the borrower. Mortgage insurance is not paid over the life of the loan, but until the principal balance of your loan reaches 78% of the original value of the property. It automatically terminates at that point, but the borrower can request mortgage insurance cancellation when the principal balance actually reaches 80% of the original value of the property. This is contingent upon having a good payment history and other criteria. By law your lender must notify you when you have reached these points. If you have a balloon loan, however, you may never reach the point during the life of the loan where the principal balance reaches 80% or 78% of the original value of the property.

Line 807. Assumption Fees are charged by lenders to pay for paperwork involved in processing records for a new buyer assuming an existing loan. When an assumption occurs the buyer agrees to take on the liability under an existing promissory note secured by a deed of trust. The lender must approve the new debtor in order to release the existing debtor from liability.

Lines 808 to 815. Over the years lenders have added new charges associated with loans. These additional lines are meant to accommodate these charges. Rarely will all of these lines be used in a closing. Some typical line items would include courier expenses incurred by the lender, underwriting fees, mortgage broker fees and buydown fees.

The 900 Section - Interim Interest and Insurance Premiums

Line 901. Line 901 is for the interest that is paid up front at the closing that covers the day of the closing up to the first of the next month, usually. When a homeowner makes his monthly mortgage payment she is paying for the previous month, not the upcoming month as when a renter pays. For example, suppose you purchase your home on March 15. Your first mortgage payment will be on

May 1. That mortgage payment covers the month of April. In the meantime the period from March 15 to April 1 must be taken care of, after all, the lender is not going to give you money interest free for those 16 days is he? Interim interest is required because everyone does not conveniently close on the first of the month. And now you know why so many closings occur near the end of the month - to save money - less interim interest to have to worry about.

Line 902. We have already discussed mortgage insurance (see Line 806). This line is for the payment of one year's mortgage insurance. It is often listed simply as MIP.

Line 903. Hazard insurance is known by most people in the world as homeowner's insurance. This is where the premium for a year's insurance is listed. The insurance protects the buyer in the event of catastrophes like a fire or a tornado. It does not cover flooding. Lenders require that you purchase hazard insurance, but it is up to you to decide where to get the policy.

Line 904. If your home is in an area where flood insurance is required the premium will be listed on this line.

The 1000 Section - Reserves or Escrows

In the first few years of your mortgage the lender will require that your monthly payments also include payments for necessary insurance premiums that protect the home, taxes and assessments. The lender pays the amounts when required. In addition, the lender requires that a portion of these funds be paid in advance. This gives the lender assurance that these important expenses are taken care of. All of the line items from 1001 to 1007 are self-explanatory. The amounts, however are not. You will see that each column is listed with the item description, such as "city property taxes" followed by a number of months x a monthly dollar value per month. The lender provides the number of months it wants collected of the particular item. The closing agent simply takes the annual amount and divides it by 12 to get the monthly value. The number of months times the monthly value is listed in the finance charges columns.

Line 1008 - Aggregate Accounting Adjustment. Before this line item was created several years ago there was a perception that lenders were requiring borrowers to place more money than was necessary in escrow accounts. The adjustment involves a projection of the anticipated activity during the first year of the escrow account. "At no time, throughout that first year, is the escrow account to total more than an amount needed to cover escrowed expenses plus a two month cushion." The adjustment will always be zero or a negative number.

The 1100 Section - Settlement Agent Fees

These are the costs attributed to the closing agent for his services, including conducting a title search of the property, preparing documents such as the deed, lien waiver, deed of trust, promissory note and powers of attorney if necessary. These fees should be known well in advance by the borrower.

Line 1108. Title insurance protects the borrower and lender against hidden risks which a title examiner might have failed to discover or could never have uncovered, such as forgery, incorrect

indexing of records, clerical errors in recording legal documents, etc. Title insurance is fairly inexpensive, costing $2.00 per $1,000.00 of value, so a $150,000.00 home will require a title policy costing $300.00. Unlike hazard insurance (lines 903 and 1001), title insurance is a one-time fee. Lenders will often require that the borrower purchase a policy. Line 1109 will show the lender's coverage, which is the amount of the loan. Line 1110 will show the owner's coverage, which is usually the purchase price of the home.

The 1200 Section - Government Recording and Transfer Charges

These fees may be paid by you or by the seller, depending upon your agreement of sale with the seller. The buyer usually pays the fees for legally recording the new deed and mortgage (Line 1201). City, county and/or state tax stamps may have to be purchased as well.

Line 1203. In North Carolina the seller normally pays for state tax stamps. These are paid by the closing agent upon recording at the register of deeds office. The rate is $1.00 per $500.00 of value of the cost of the purchase. For example, a $75,000.00 home would require taxes of $150.00 (75,000 divided by 500).

The 1300 Section - Additional Settlement Charges

This is a miscellaneous section that covers costs that don't readily fit into the categories already mentioned. These lines may or may not be filled out. Also realize that some closing agents will use the other blank lines in the 800 section and 1100 section for additional charges.

Line 1301. The lender may require that a survey be done for the property that will be purchased. This is a protection to the buyer and seller. Usually this is paid by the buyer. You will be entitled to copies of the survey and the surveyor's report.

Line 1302. Pest inspections cover the costs of having a termite or other pest infestation reports done of the home. This is typically a buyer cost and is required by most lenders.

Line 1400 - Total Settlement Charges

The sum of all fees in the borrower and seller's columns is placed here. These figures are transferred to page one of the HUD-1 on lines 103 and 502, respectively.

PAGE 1

The first page of the HUD-1 summarizes all the costs and adjustments for the borrower and seller. Section J is the summary of the borrower's transaction and Section K is the summary of the seller's side of the transaction. Since this brochure is primarily for the buyer we will not focus much on the right side of the HUD-1 which is Section K.

The 100 Section - Summary of Borrower's Costs

Section 100 summarizes the borrower's costs, such as the contract cost of the house, any personal property being purchased, and the total settlement charges owed by the borrower from Section L.

Line 101. This will list the contract sales price as agreed upon in your offer to purchase.

Line 102. Are you purchasing more than the house? The land and the house is called real property. That is what you contracted to purchase. Sometimes the seller will sell other items in the house such as a satellite dish, refrigerator, stove, above ground pool. These are things which can be relatively easy to move and are called personal property. The cost of these items would be listed here.

Line 120. The items on lines 101, 102 and 103 (which is also Line 1400), are totaled to come up with the figure on Line 120. For the moment we will leave "adjustments for items paid by seller in advance" for later.

The 200 Section - Amounts Paid By or in Behalf of Borrower

Line 201. The borrower normally has paid to the real estate agent or the settlement agent money which represents good faith that she will go through with the purchase of the home. This money is counted toward the purchase price and is subtracted from the amount listed on Line 120.

Line 202. This is the full amount that the home buyer is borrowing from the lender. This too is subtracted from the amount listed on Line 120.

Line 203. In the instance in which a borrower assumes a mortgage the balance on the mortgage is subtracted from the amount listed on Line 120.

Line 220. All items listed from Line 201 through Line 219 are added up here. This is the total amount paid by or for the borrower to purchase the home. This amount is subtracted from Line 301/Line 120 to arrive at the amount at Line 303.

Line 303. This line has a monetary figure and it is important to see which box is checked. The difference determines whether the borrower will have to bring cash to the closing in the amount listed in the column or whether the borrower will actually receive cash at the closing.

Adjustments for Items Shared by the Buyer and Seller

At settlement it is usually necessary to make an adjustment between buyer and seller for property taxes and other expenses. The adjustments are shown in the sections marked "Adjustments for items paid by seller in advance" and "Adjustments for items unpaid by seller." In using taxes as our primary example, let's say that the seller of the house has already paid property taxes for the year and the taxes are paid on an annual basis. In that case the taxes would be prorated, or divided proportionately, between the buyer and seller. The closing agent would determine the tax and divide it by the number of days in the year. Based upon the day of the closing the buyer would pay the

seller for the tax time she assumes ownership of the home, because it would be unfair for the seller to pay taxes for the whole year when he didn't own it for a full year. The tax the buyer would have to pay for her time as owner is listed on Line 106 or 107 as necessary. This will also be paid to the seller and is a part of the Gross Amount Due From Borrower in Line 120 and Line 301.

Sometimes taxes have not been paid. If this is the case the tax for the time that the seller owned the property during the tax year is listed on Line 210 or Line 211. This amount is subtracted from what the buyer has to pay.

This is the HUD-1 in a nutshell. The closing agent is responsible for explaining this document to you in detail. If you have questions ask. Under the Real Estate Settlement Procedures Act (RESPA) you are entitled to a copy of the HUD-1 twenty-four hours before the closing. Don't be shy to ask for your copy and use this brochure to help explain it to you. Following is an example of a completed HUD-1. Use it as a reference in your own closing. Realize that costs for services will vary and are not meant to be indicative of everyone's circumstances.

HUD – 1
PAGE 1

A.

SETTLEMENT STATEMENT

U.S. Department of Housing and Urban Development

OMB No. 2502-0265

B. Type of Loan
1. [X] FHA 2. [ ] FmHA 3. [ ] Conv.Unins
4. [ ] VA 5. [ ] Conv. Ins.

6. File Number: 0238

7. Loan Number: 44556677

8. Mortgage Ins. Case #: 381 3894406 796

C: Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the Settlement Agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for information purposes and are not included in the totals.

D. Name and Address of Borrower
HENRY NEWHOUSE BUYER and
WIFE STELLA BUYER
224 COTTON PARK DRIVE
CHARLOTTE, NC 28217

E. Name and Address of Seller
JAMES Q. SELLER and JANE
SELLER
1433 EBONYWOOD DRIVE
CHARLOTTE, NC 28210

F. Name and Address of Lender
N & D MORTGAGE CORPORATION
3331 LITTLE BEAVER ROAD, STE
TROY, MICHIGAN 48084

G. Property Location
224 COTTONSEED DRIVE
CHARLOTTE, NC 28299

H. Settlement Agent
KEITH D. HEMPSTEAD, ATTORNEY AT LAW

Place of Settlement
331 W. MAIN ST. SUITE 605
DURHAM, NC 27701

I. Settlement Date
8/18/96
DISB.DATE:
8/21/96

J. Summary of Borrower's Transaction		K. Summary of Seller's Transaction	
100. Gross Amount Due From Borrower		400. Gross Amount Due To Seller	
101. Contract sales price	86,950.00	401. Contract sales price	86,950.00
102. Personal property		402. Personalproperty	
103. Settlement charges to borrower (line1400)	6,503.22	403.	
104.		404.	
105.		405.	
Adjustments for items paid by seller in advance		Adjustments for items paid by seller in advance	
106. City/town taxes 8/18/96 to 12/31/96	464.48	406. City/town taxes 8/18/96 to 12/31/96	464.48
107. County taxes 8/18/96 to 12/31/96	278.69	407. County taxes 8/18/96 to 12/31/96	278.69
108. Assessments to		408. Assessments to	
109. SEWER ASSESSMENT	150.00	409. SEWER ASSESSMENT	150.00
110.		410.	
111.		411.	
112.		412.	
120. Gross Amount Due From Borrower	94,346.39	420. Gross Amount Due To Seller	87,843.17
200. Amounts Paid By or in Behalf of Borrower		500. Reduction in Amount Due To Seller	
201. Deposit or earnest money	700.00	501. Excess deposit (see instructions)	0.00
202. Principal amount of new loan(s)	85,000.00	502. Settlement charges to seller (line 1400)	8,346.60
203. Existing loan(s) taken subject to		503. Existing loans taken subject to	
204.		504. Payoff of first mortgage loan	70,174.50
205.		505. Payoff of second mortgage loan	
206.		506. REPAIRS TO ABC BUILDERS	250.00
207.		507.	
208.		508.	
209.		509.	
Adjustments for items unpaid by seller		Adjustments for items unpaid by seller	
210. City/town taxes to		510. City/town taxes to	
211. County taxes to		511. County taxes to	
212. Assessments to		512. Assessments to	
213.		513.	
214.		514.	
215.		515.	
216.		516.	
217.		517.	
218.		518.	
219.		519.	
220. Total Paid By/For Borrower	85,700.00	520. Total Reduction Amount Due Seller	78,771.10
300. Cash At Settlement From/To Borrower		600. Cash At Settlement To/From Seller	
301. Gross Amount due from Borrower (line 120)	94,346.39	601. Gross amount due to Seller (line 420)	87,843.17
302. Less amt paid by/for borrower(line 220)	(85,700.00)	602. Less reduction in amt due seller(ln 520)	(78,771.10)
303. Cash [X] From [ ] To Borrower	8,646.39	603. Cash [X] To [ ] From Seller	9,072.07

REPORTER TAX ID # 241-17-3734 PHONE (919) 682-2748

The amount on line 401 on this form is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported. This is a substitute form 1099-S.

JAMES Q. SELLER TAX ID # 333-33-3333

Previous Edition is Obsolete

HUD-1 (3-86)
RESPA, HB 4305.2

HUD – 1
PAGE 2

L. Settlement Charges	Paid From Borrower's Funds at Settlement	Paid From Seller's Funds at Settlement
700. Total Sales/Broker's Commission based on price $ 86,950.00 @ 6.00 %		
Division of commission (line 700) as follows:		
701. $ 2,608.50 to CENTURY 21		
702. $ 2,608.50 to RYDER REALTY		
703. Commission paid at settlement		5,217.00
704.		
800. Items Payable in Connection With Loan		
801. Loan origination Fee .88 % N & D MORTGAGE CORPORATION	750.00	
802. Loan Discount 2.00 % N & D MORTGAGE CORPORATION		1,700.00
803. Appraisal Fee to 200.00 POC TO N AND D MTG.		POC
804. Credit report to 50.00 POC TO N AND D MTG.	POC	
805. Lender's Inspection Fee N & D MORTGAGE	25.00	50.00
806. Mortgage Insurance Application Fee to		
807. Assumption Fee		
808. HUD INSURANCE PREMIUM	3,205.30	
809. TAX SERVICE FEE TO N & D MORTGAGE		66.50
810.		
811.		
812.		
813.		
814.		
815.		
900. Items Required By Lender To Be Paid In Advance		
901. Interest from 8/21/96 to 9/1/96 @$ 22.72 /day	249.92	
902. Mortgage Insurance Premium for 6 months to ALLSTATE	200.00	
903. Hazard Insurance Premium for 1 years to REALTY INS	360.00	
904.		
905.		
1000. Reserves Deposited With Lender		
1001. Hazard Insurance 10 months @$ 45.00 per month	450.00	
1002. Mortgage Insurance 0 months @$ 33.34 per month	0.00	
1003. City Property Taxes 7 months @$ 100.00 per month	700.00	
1004. County Property Taxes 0 months @$ 62.50 per month	0.00	
1005. Annual Assessments months @$ per month		
1006. Flood Insurance months @$ per month		
1007. Sanitary Tax months @$ per month		
1008. AGGREGATE ACCOUNTING ADJ months @$ per month	-90.00	
1100. Title Charges		
1101. Settlement or closing fee to		
1102. Abstract or title search to		
1103. Title examination to		
1104. Title insurance binder to		
1105. Document preparation to		75.00
1106. Notary fees to		
1107. Attorney's fees to KEITH D. HEMPSTEAD, ATTORNEY	250.00	250.00
(includes above item numbers: 1101-1107)		
1108. Title insurance to FIDELITY TITLE	178.00	
(includes above item numbers:)		
1109. Lender's coverage $ 87,300.00		
1110. Owner's coverage $ 88,050.00		
1111.		
1112.		
1113. 1994 AD VALOREM TAXES		131.00
1200. Government Recording and Transfer Charges		
1201. Recording fees: Deed $ 8.00 ; Mortgage $ 12.00 ; Releases $ .00	20.00	
1202. City/county tax/stamps: Deed $; Mortgage $		
1203. State tax/stamps: Deed $ 178.00 ; Mortgage $ .00		178.00
1204. ASSIGNMENTS	10.00	
1205.		
1300. Additional Settlement Charges		
1301. Survey to ABC SURVEY CO.		300.00
1302. Pest inspection to CLEGGS EXTERMINATING	65.00	
1303. H20 OF THE CAROLINAS		275.00
1304. BP OIL CREDIT CARD PAYOFF		104.10
1305. LEROY SMALL PAYOFF	130.00-	
1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)	6,503.22	8,346.60

I have carefully reviewed the HUD-1 Settlement Statement and to the best of my knowledge and belief, it is a true and accurate statement of all receipts and disbursements made on my account or by me in this transaction. I further certify that I have received a copy of the HUD-1 Settlement Statement.

HENRY NEWHOUSE BUYER — JAMES Q. SELLER

Borrowers STELLA BUYER — Sellers JANE SELLER

The HUD-1 Settlement Statement which I have prepared is a true and accurate account of this transaction. I have caused or will cause the funds to be disbursed in accordance with this statement.

Settlement Agent KEITH D. HEMPSTEAD, ATTORNEY AT LAW — Date 8/18/96

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CHAPTER N

TAX PAYMENTS, OTHER TAXES, & FINISHING THE RETURN

OUTLINE OF INSTRUCTION

I. REFERENCES.

A. Tax Forms: 1040, Schedule SE, 6251, 4137, 5329, 5405, 8888, 8812, 8863, Schedule H (Household Employment Taxes), Schedule M (Making Work Pay Credit).

B. Internal Revenue Code of 1986, as amended (I.R.C.).

C. Federal Income Tax Regulations (Treas. Reg.).

D. IRS Publications:

1. Pub. 17, Your Federal Income Tax.

2. Pub. 926, Household Employer's Tax Guide

3. Pub. 531, Reporting Tip Income

II. TOTAL TAX.

A. A taxpayer's income tax is based on his or her taxable income, as determined by determining the taxpayer's income and deductions.

B. After the taxpayer's income tax and AMT, if any, is determined, the taxpayer must subtract any applicable tax credits and add any other taxes owed. The result is the taxpayer's total tax.

C. The taxpayer's total tax is compared to his or her total tax payments (e.g. withholdings as shown on the taxpayer's W-2) to determine if a refund or additional tax payment is warranted.

III. OTHER TAXES.

A. Self-employment Tax (Schedule SE).

1. An individual who is self-employed is subject to the self-employment tax, the purpose of which is to provide social security benefits. This tax is assessed on the individual's self-employment income. I.R.C. § 1401 – 1402.

2. It does not include rental income (unless taxpayer is a real estate dealer), dividends, or capital gains.

3. Individuals that had net earnings from self-employment over $400 are subject to the tax.

   a. Net earnings from self-employment consists the gross income derived from any trade or business, less allowable deductions attributable to the trade or business and the taxpayer's distributive share of the ordinary income or loss of a partnership engaged in a trade or business. Treas. Reg. § 1.1402(a)-1.

   b. There are special rules for computing net earnings from self-employment. I.R.C. § 1402(a).

4. U.S. Citizens or Resident Aliens Living Outside the U.S. I.R.C. § 1402(a)(11):

   a. In most cases, self-employed U.S. citizens or resident aliens living outside the U.S. must pay the self-employment tax. The taxpayer may not reduce foreign earnings from self-employment by the foreign earned income exclusion.

b. The U.S. has social security agreements with many countries to eliminate dual taxes under two social security systems. Under these agreements, the taxpayer must generally pay social security and Medicare taxes to only the country where they reside.

c. The U.S. now has social security agreements with Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, South Korea, Sweden, Switzerland, the United Kingdom, and the Slovak Republic (as of May 1, 2014). Additional agreements are expected in the future.

5. The combined rate of tax on self-employment income is 15.3%. That rate consists of a 12.4% for social security, and a 2.9% component for Medicare. Beginning in 2013, there is a 3.8% (2.9% regular Medicare tax plus 0.9% additional Medicare tax) on all self-employment income in excess of $200,000 ($250,000 of combined self-employment income on a joint return, $125,000 for married taxpayers filing a separate return. Code Sec. 1401(b)(2). Use Form 8959, Additional Medicare Tax, to figure the additional Medicare tax.

6. For 2016, the maximum amount of self-employment income subject to social security tax was $118,500 (same of $118,500 in 2015) and may change for 2017. There is no longer a cap for the Medicare component.

7. The self-employment tax is calculated on the Schedule SE.

a. The self-employment tax will be entered on line 5 of Schedule SE.

b. The self-employment tax will carry over to Form 1040.

c. As previously mentioned, a deduction for one-half of the self-employment tax is indicated on Schedule SE, line 6, and transferred to Form 1040 as an adjustment to income.

d. Married couples filing a joint return must file separate Schedules SE where each spouse is self-employed.

B. Alternative Minimum Tax (AMT) (Form 6251).

1. The AMT rules have been devised to ensure that at least a minimum amount of tax is paid by high income taxpayers who reap large tax savings by making generous use of certain tax deductions and exemptions. Without the AMT, some taxpayers might be able to escape income taxation entirely. The AMT is a separate tax system with its own set of rules. I.R.C. § 55.

2. The AMT is the excess, if any, of the tentative minimum tax for the year over the regular tax for the year.

3. No specific tests to determine if taxpayer owes AMT. Figure regular income tax and then see whether tax benefit items must be added back (see worksheet in Form 1040 Instructions).

4. Taxpayer uses Form 6251 to determine liability. The IRS website has a new feature, the AMT Assistant, to help taxpayers evaluate whether the AMT will apply to their return. The IRS AMT assistant is available http://www.irs.gov/uac/Tools.

5. The AMT now appears after the line for calculating the regular tax instead of in the section for other taxes. The change was designed to simplify the AMT calculation of the offset for personal credits for dependent care, education, and child tax credit allowed against the minimum tax.

6. AMT rates:

a. 26% rate applies to AMT taxable income of less than $186,300 in 2016 (after the AMT exemption) for married filing jointly, $93,150 in 2016 for married filing separately. This amount is adjusted for inflation.

b. 28% rate applies to AMT income above $185,400 (adjusted for inflation as stated above) for married filing jointly, $92,700 for married filing separately.

7. The Alternative Minimum Tax exemption amounts for tax year 2016 are as follows:

   a. $53,900 for single taxpayers in 2016;

   b. $83,800, for married couples filing jointly taxpayers in 2016;

   c. $41,900 for married filing separate taxpayers in 2016.

8. AMT exemptions are phased out by an amount equal to 25 percent of the amount by which the AMT income of the taxpayer exceeds:

   a. $159,700 in the case of a joint return;

   b. $119,700 in the case of a single return; and

   c. $79,850 in the case of married filing separately.

C. Social Security and Medicare Tax on tip income not reported to employer (Form 4137).

1. Cash tips paid directly to an employee by a customer and tips paid over to the employee for charge customers must be accounted for by the employee in a written statement furnished to the employer on or before the 10th day of the month following the month when they are received, unless the tips received by the employee in the course of employment by a single employer amount to less than $20 in a calendar month. I.R.C. § 3121(a)(12); 3401(a)(16); 6053(a).

2. All of the tips mentioned above are subject to withholding. I.R.C. § 3401(a)(16)(B). However, the only tips that an employer must report on Form W-2 are those that are actually reported to him by the employee. I.R.C. § 6051(a).

3. If a taxpayer received tips of $20 or more in any month and did not report the full amount to their employer, they must pay the social security and Medicare tax on the unreported tips.

4. The tax is computed on Form 4137, and the amount of the tax transferred to Form 1040.

5. A taxpayer may be charged a penalty equal to 50% of the social security and Medicare tax due on tips if they did not report them to their employer.

D. Net Investment Income Tax (I.R.C. § 1411)

1. For tax year 2013 and beyond, certain unearned income of individuals, trusts, and estates is subject to a 3.8% surtax (i.e., it is payable on top of any other tax payable on that income).

2. For individuals, the surtax on unearned income (also called the unearned income Medicare contribution tax or the net investment income tax) is 3.8% of the lesser of:

   a. net investment income; or

   b. the excess of modified adjusted gross income (MAGI) over an unindexed threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case).

3. Net Investment Income is the excess of the sum of the following items over investment expenses (except interest) directly connected with the production of investment income (Treas. Reg. §1.1411-4):

   a. Gross income from interest, dividends, annuities, royalties, rents, and substitute interest and dividend payments, but not to the extent this income is derived in the ordinary course of an active trade or business;

b. Other gross income from passive activity under I.R.C. § 469, or from a trade or business of a trader trading in financial instruments or commodities;

c. Net gain included in computing taxable income that is attributable to the disposition of property, but not to the extent the property was held in an active trade or business.

4. The net investment income is reported on IRS Form 8960.

E. Tax on Unearned Income of Children – "Kiddie Tax"

1. Under the "kiddie tax" rules, certain children are taxed at their parents' highest tax rate on the child's unearned income over $2,100 for 2016, if that tax is higher than what the child would otherwise pay on it.

2. For 2016, the child's first $1,050 of unearned income is not taxed at all, the next $1,050 of unearned income is taxed at the child's rate, and the child's "excess" unearned income is taxed at the parent's marginal rate.

3. The parents can, if certain conditions are met, elect to include the child's gross income on their own return.

4. A child is subject to the kiddie tax if:

a. the child either –

(1) is under age 18 at the end of the tax ear, or

(2) is age 18, or 19-23 if a full-time student, at the end of the tax year and his earned income does not exceed one-half of his support;

b. either parent is alive at the end of the tax year;

c. the child does not file a joint return for the tax year; and

d. the child's unearned income is more than $2,100 for 2016. I.R.C. § 1(g)(2).

5. A child subject to the kiddie tax pays a tax computed on Form 8614, attached to the child's Form 1040 or 1040A.

6. The parents of a child may elect to include on their return the unearned income of a child to avoid the kiddie tax. The election can only be made under certain enumerated requirements. (I.R.C. 1(g)(7); Rev. Proc. 2013-15; Rev. Proc. 2013-35).

a. The election is made by filing Form 8814. Electing parents are then taxed on their child's income in excess of $2,100.

F. Additional tax on IRAs, Qualified Plans and other tax favored accounts (Form 5329).

1. Taxpayer includes distributions received before age 59-1/2 in gross income (Form 1040, line 15). In addition, the taxpayer must pay a 10% penalty. Withdrawals before age 59 ½ are called premature or early withdrawals. This penalty is 10% of the part of the distribution that the taxpayer must include in gross income.

2. Additional 10% penalty is imposed on the premature withdrawal from an IRA, or other qualified retirement plan. This tax is in addition to any regular tax due.

3. There are a number of exceptions to the 10% penalty, if one applies see the instructions for Form 5329 for the code to place on the form to exempt the distribution from the penalty:

a. The receipt of a distribution from a traditional IRA that includes a return of nondeductible contributions is not subject to the 10% penalty.

b. The 10% penalty does not apply if taxpayer dies, or becomes disabled. I.R.C. § 72(t)(3)(A).

c. Unemployed individuals: To the extent that they do not exceed qualifying medical insurance premiums, distributions by an IRA to certain unemployed individuals are not subject to the 10% penalty. I.R.C. § 72(t)(2)(D).

d. Qualified higher education expenses: The 10% penalty will not be charged if the individual uses the IRA money to pay for qualified higher education expenses for the individual, the spouse, child, or grandchild of the individual or their spouse. Qualified expenses for this exception are the same as for education credits. I.R.C. § 72(t)(2)(E).

e. First time homebuyer expenses: The 10% penalty will not be charged if the individual uses the IRA money for certain expenses associated with buying a principal residence. Only $10,000 during the individual's lifetime may be withdrawn without a penalty for this purpose. I.R.C. § 72(t)(2)(F).

(1) Qualified expenses include acquisition costs, settlement charges and closing costs.

(2) The principal residence may be for the individual or the individual's spouse, child, grandchild or ancestor.

(3) In order to be considered a first time homebuyer, the individual must not have had an ownership interest in a principal residence during the two-year period ending on the date that the new home is acquired. I.R.C. § 72(t)(8)(D) (principal residence as defined in I.R.C. § 121).

f. Annuity exception - taxpayer may receive distributions without penalty if distributions are part of a series of substantially equal payments over taxpayer's life, even if taxpayer is less than age 59 ½. Two special requirements:

(1) At least 1 distribution annually, and

(2) Distribution payments continue for at least 5 years or until taxpayer reaches 59 ½, whichever is longer.

g. If a taxpayer made a contribution to an IRA during the tax year, and withdraws the money before the due date of the tax return, he will not be subject to the 10% penalty. If a taxpayer has an extension of time to file a tax return, the taxpayer can withdraw the money from the IRA tax free by the extended due date. However, the taxpayer must also withdraw any interest or other income earned on the contributions and include that in income.

h. Qualified Reservist Distribution. If ordered after Sept 11, 2001 to active duty for at least 180 days and take a distribution during time of active duty from a qualified retirement plan then not subject to the penalty. (I.R.C. § 82(t)92)(G)(i)).

4. Taxpayers receiving premature distributions must complete IRS Form 5329 and enter the amount of the tax on Form 1040.

G. Household Employment Taxes (Schedule H, See IRS Pub. 926).

1. If a taxpayer employs someone to care for children or disabled dependents in their home (clean, cook, or provide other personal services in or around the home) the taxpayer may be obligated to pay and withhold Social Security and Medicare taxes (FICA) and also pay federal unemployment taxes (FUTA). FICA or FUTA taxes do not apply if the household worker is the employee of an agency that assigns the position, sets the fee, and requires reports from the worker.

2. "Nanny tax." The Social Security Domestic Employment Reform Act of 1994 (H.R. 4278, 103rd Cong., 2d Sess. (1994)) changed existing rules on reporting and withholding Social Security taxes that household employees earn in a taxpayer-employer's home.

a. In 2016, a $2,000 annual wage threshold (per domestic employee) for Social Security taxes on wages earned by domestic service employees (I.R.C. § 3121(a)(7)(B)).

b. An employer of household employees is liable for FUTA taxes if they paid cash wages of $1,000 or more for household services during any calendar quarter, or if they did so in any quarter in the preceding year. However, you do not have to count wages paid to your spouse, your child who is under 21, or to your parent.

c. Household employers report and pay Social Security, Medicare or Federal Unemployment (FUTA) taxes annually on their own federal income tax return (see Schedule H).

d. Effective January 1, 2013 and beyond, Additional Medicare Tax applies to an individual's Medicare wage that exceeds a threshold amount based on the taxpayer's filing status. Employers are responsible for withholding the 0.9% Additional Medicare Tax on an individual's wages paid in excess of $200,000 ($250,000 MFJ; $125,000 MFS) in a calendar year.

e. A taxpayer should file a Form W-2 for each household employee to whom they paid Social Security and Medicare wages, or wages from which the taxpayer withheld federal income tax.

f. Employers need an employer identification number (EIN) to include on Form W-2 and Schedule H. To obtain an EIN, employers should complete Form SS-4.

g. Household workers under age 18 are exempt from Social Security taxation and coverage UNLESS their principal occupation is household employment.

3. The tax is computed on Schedule H and entered on Form 1040, line 62.

Example 1: The wages of a 17-year old student who also baby-sits will be exempt from the reporting and payment requirements, regardless of the amount of wages earned. In this case, the $2,000 wage threshold is negated because the employee is under 18, and baby-sits as a sideline.

Example 2: The wages of a 17-year old mother who leaves school and goes to work as a domestic service employee to support her family will be subject to the reporting and payment requirements, IF the amount of wages earned exceeds $2,000 in the year. In this case, the under 18 provision is negated because the employee's regular occupation is domestic work.

IV. CREDITS.

A. A credit is a dollar-for-dollar reduction of the taxpayer's tax liability.

1. After the taxpayer determines his or her income tax and any AMT, the taxpayer should determine if he or she is eligible for any tax credits.

2. *See* Tax Credit outline for a list of credits and their eligibility requirements.

B. Other Credits. Excess Social Security and RRTA tax withheld. I.R.C. 31(b)(1).

1. If a taxpayer or spouse had more than one employer for the tax year and had total wages of more than $118,500, too much social security tax may have been withheld.

2. Taxpayers can take a credit on Form 1040 for the amount of social security tax withheld in excess of $7,347 (the maximum amount to be withheld).

3. If any one employer withheld more than $7,347, the taxpayer must ask the employer to refund the excess.

V. PAYMENTS.

A. Federal income tax withheld from Forms W-2 and 1099.

1. Withholding of income tax by an employer is required only on an employee's wages. I.R.C. § 3401(a).

2. Salaries, fees, bonuses, commissions on sales or on insurance premiums, taxable fringe benefits, pensions and retirement pay (unless taxed as an annuity) are, if paid as compensation for service, subject to withholding. Treas. Reg. 31.3401(a)-1(a)(2).

3. Wage withholding is a pay-as-you-earn tax system. Federal income tax taken out of the taxpayer's pay is shown in box 2 of Form W-2.

4. Federal income tax can also be withheld on payments from pension plans, annuities, and IRAs. The tax withheld is reported on Form 1099-R, box 4.

5. Some income tax is withheld from income reported on other Form 1099s.

6. Add all of the federal income tax withheld from the above sources and enter on Form 1040.

B. Estimated Tax Payments and Amount Applied from Prior Year Tax Return. (Form 1040-ES).

1. An individual must make four quarterly installment payments of estimated tax based on the amount of his "required annual payment" to avoid an underpayment penalty. The required annual payment is the lower of 90% of the tax shown on the current year return or 100% (110%, for high income individuals) of the tax shown on the prior year return.

   a. Taxpayers make estimated tax payments on income that is not subject to withholding or when the tax withheld is inadequate.

   b. Taxpayers use Form 1040-ES to make estimated tax payments. If the taxpayer made estimated tax payments during the tax year the total amount of the payments is entered on Form 1040.

2. If the taxpayer had an overpayment in 2015, and applied part or all of it to their estimated tax in the current year, indicate the amount on line 65 of Form 1040.

C. Amount Paid With Request for Extension to File.

1. If the taxpayer filed Form 4868 or used a credit card to get an automatic extension of time to file Form 1040, the taxpayer enters any amount that was paid with the extension form or by credit card.

2. If the taxpayer paid by credit card, the amount of the convenience fee charged by the credit card company <u>is not included</u> in the payment.

D. Other Payments (Form 2439; Form 8839, Form 8801, Form 8885).

1. Any tax paid by a regulated investment company or real estate investment trust may provide a tax credit to taxpayer on Form 2439: Notice to shareholder of undistributed long-term capital gains.

2. Any tax credit available to taxpayer from qualified adoption credits is reported on Form 8839.

3. Any tax credit available to taxpayer from federal tax paid on health insurance is calculated on Form 8885.

4. A taxpayer with any of these three types of credits checks the appropriate box and enters the credit on Form 1040.

E. Total Payments.

1. All payments are added together.

2. The sum is the total tax paid during the tax year.

VI. REFUND.

A. If the taxpayer has made more tax payments during the tax year than the total tax due, the taxpayer has overpaid taxes for the tax year.

B. The taxpayer can elect to have an overpayment refunded. This will result in a check mailed to the taxpayer, direct deposit of the refund if elected by the taxpayer, or the taxpayer can elect to use the refund to purchase Series I Savings Bonds.

C. The taxpayer can elect to have a refund direct deposited to a bank account using form 8453.

1. Double check Routing Number and Account Number with a voided check.

2. Require proof of ownership of account.

a. *NOTE*: A military employee used the Volunteer Income Tax Assistance (VITA) program to electronically file her return. A person with access to the VITA site changed the bank deposit account and routing numbers, causing the refund to be deposited into a service member's bank account. The service member immediately spent the money, but denied having knowledge of how it got in his account. Although the military suspected that the sailor had a friend with access to the VITA computers and that that person changed the bank routing and account numbers, it filed no charges in the case. After reimbursing the employee for the missing refund, the military asked the IRS to refund the misappropriated money to the employee so she could reimburse the military. The IRS concluded it may issue a second income tax refund to an individual whose electronic refund deposit was fraudulently re-routed to a third person. *I.R.S. Field Service Advice*, FSA 2000-38-005 (June 6, 2000), available at *Tax Notes Today*, 2000 TNT 186-60 (September 25, 2000).

D. Split Refunds. (Form 8888)

1. Taxpayers have the option to divide their direct deposit refund between a maximum of three different accounts.

2. The accounts must be maintained in U.S. financial institutions.

3. To split a refund, the refund amount must be at least $1.00 or more.

4. Refunds can be split to various accounts as long as the account is one with a routing number and account number. This includes, savings accounts, checking accounts, IRAs, money markets, debit cards, and education savings accounts. A refund cannot be directed to a loan account.

5. Ordering Rules---or what happens if my refund is not what I thought it would be?

   a. IRS must reduce the refund: Bottom up rule

      (1) The IRS will first deduct the difference from the amount designated for the last listed account on the Form 8888.

      (2) If the difference exceeds the refund designated for this account, the IRS will go to the next listed account etc.

   b. IRS must increase the refund: All to the last account listed.

   c. IRS Offset: If the IRS offsets a refund for delinquent state income taxes, back child support, or delinquent federal debts like student loans, the FMS will deduct the amount due from the account that appears first on the payment file received by FMS from the IRS. The IRS payment file orders accounts from the lowest to the highest routing number---which may not correspond with the split refund order rules.

6. Anyone whose refund is changed will receive a letter from the IRS explaining the adjustments.

7. Anyone who wants a direct deposit into a single account does not use the Form 8888, they still simply indicate the routing and account numbers on the Form 1040.

E. Refund Offset:

1. If a taxpayer owes a past-due federal tax, state tax, child support, spousal support, or certain federal nontax debts, such as student loans, all or part of an overpayment (refund) may be used to pay the past-due amount.

a. Priorities for Offset.

(1) First, by amount of any past-due support assigned to a state;

(2) Second, by the amount of any past-due, legally enforceable debt owed to a federal agency;

(3) Third, by the amount of any qualifying past-due support not assigned to a state; and

(4) Fourth, by the amount of any past-due legally enforceable state income tax obligation.

b. States can seek an offset for federal income tax refunds payable after December 31, 1999. I.R.C. § 6402(e)(2). As extended to state income tax debts, the program allows the state taxing authorities to ask the federal government to offset a taxpayer's federal income tax refund against the taxpayer's state income tax liabilities. Thus, the federal government acts as a collection arm for the states. 31 C.F.R. Part 285; 64 F.R. 71228 (December 20, 1999).

(1) The state first must show that is has made reasonable efforts to collect the tax.

(a) The term “State” means not only the States of the United States, but includes the District of Columbia, American Samoa, Guam, the U.S. Virgin Islands, Commonwealth of the Northern Mariana Islands, and the Commonwealth of Puerto Rico.

(b) “State income tax” includes all taxes determined under state law to be State income tax, and includes any local income tax that is administered by the chief tax administering agency of the State.

(2) Second, the state must notify the taxpayer of its intent to offset the taxpayer’s federal refund claim and give the taxpayer 60 days to demonstrate that the state tax levy is not past due or not unenforceable.

(3) States are required to certify compliance with pre-offset procedures imposed by state law or procedures.

(a) The certification and pre-offset procedures include a requirement that states provide debtors with notice that they intend to collect the debt by referral to the Treasury for tax refund offset;

(b) That states afford debtors the opportunity to present evidence that all or part of the debt is not due; and

(c) That states establish procedures for reviewing evidence presented by debtors.

(4) For refunds payable after December 31, 1999, the IRS will only be able to apply a refund for a tax year to offset state tax obligations if the address shown on the Federal return for the year of the overpayment is within the state seeking the offset.

(a) If the taxpayer moves to a different state, he is effectively exempt from application of a refund for a year after the move to a State tax obligations owed to the State from which he has moved.

(b) The address shown on the return is controlling for this purpose. Thus, literally read, even if a taxpayer actually continues to reside within the state seeking the offset, if he files the return showing an address outside that state, IRS cannot apply the refund offset.

(5) The reduction of a taxpayer's refund for past due State tax is not subject to review by any court of the U.S. or by the Secretary of the Treasury, Financial Management Service, or the I.R.S. in an administrative proceeding. I.R.C. § 6402(f).

2. A taxpayer subject to offset will receive a notice from the Treasury Department's Financial Management Service showing the amount of the offset and the agency receiving it.

VII. AMOUNT OWED.

A. If the total tax due is more than the total tax payments for the tax year, then the taxpayer will owe money.

1. The amount owed will be indicated on Form 1040.

2. If there is an amount owed, the taxpayer should include with the tax return, a check or money order payable to the United States Treasury for the entire amount owed.

3. The taxpayer may use a credit card to pay amount owed. The credit card company usually charges a convenience fee that varies by card service. Call 800-272-9829 or 888-729-1040 to arrange credit payments, or go to www.irs.gov for list of credit card processing companies.

4. The taxpayer can pay by electronic debit from a bank account.

5. The payment should be enclosed, but not attached to the return. The taxpayer's name, address, social security number, daytime telephone number, and "2016 Form 1040" should be written on the payment.

6. If the taxpayer cannot pay the full amount, he/she can ask for permission to make monthly installment payment. To ask for an installment agreement, the taxpayer should file an Installment Agreement Request (Form 9465) with the tax return.

   a. On Form 9465, the taxpayer may request a monthly payment plan. The IRS will inform the taxpayer within 30 days if the proposed payment plan is accepted.

   b. If the monthly payment plan is approved, the taxpayer will have to pay a processing fee, interest, and possibly a late-payment penalty on the amount not paid by the due date.

   c. If the taxpayer owes $10,000 or less and certain conditions are met, the IRS must enter into an installment arrangement if requested. The taxpayer must show that full payment cannot be currently made, and that in the previous five years the taxpayer filed income tax returns and paid the tax and did not enter into an installment arrangement during that period.

   d. If amount due, including interest and penalty, is $25,000 or less, the taxpayer can apply online for an installment agreement at www.irs.gov.

B. Estimated Tax Penalty.

1. If the amount owed is $1,000 or more and it is more than 10% of the tax shown on the return, or if the taxpayer underpaid his prior year estimated tax liability, the taxpayer may owe a penalty for underpayment of estimated tax.

2. If the exceptions to the penalty do not apply to the taxpayer, the penalty is calculated on Form 2210 or you can allow the IRS to make the calculation and notify the taxpayer of the penalty.

3. A taxpayer subject to the estimated tax penalty will include the penalty on Form 1040.

VIII. FINISHING THE RETURN.

A. Taxpayer Identification Section.

1. Signature Section.

a. Electronic Filing: Return still has to be signed to be validly filed if it is electronically submitted. The signature form is Form 8879, generated by the software.

(1) Use the Practitioner Pin method for your tax center. The Practitioner Pin will be your center's EFIN and 98765 which designates the return as a VITA return.

(2) The Form 8879 no longer has to be maintained by the tax center for 3 years. However, military tax centers must retain Form 8879 thru 31 December of the filing year.

(3) If a POA is used or a Form 8332, giving dependent exemption to non-custodial parent, must file a Form 8453 in addition to the 8879. The 8453 transmits the attached POA or Form 8332 and the Form 8879 is still the signature document.

b. Joint return:

(1) How to get both husband and wife signature on a joint return in a tax center?

(2) Require both husband and wife to come into tax center at the same time?

(3) System to allow for one spouse to come into tax center (without children), prepare return, sign return, and then the other spouse to return later to sign the return.

c. When a signature appears on a joint tax return, there is a rebuttable presumption that each spouse has signed his/her name. I.R.C. § 6064.

(1) In the past, the Internal Revenue Manual instructed IRS agents that a signature on a return was prima facie evidence that the person whose name appears on the document actually signed the return and to disallow any claim that a spouse's signature on a joint return was forged.

(2) A spouse who files a joint return can rebut the presumption under I.R.C. § 6064 that she actually and willingly signed a joint return. The spouse seeking relief must prove that the signature was forged and he/she did not intend to file a joint return. I*.R.S. Legal Memorandum* 1999-43-001, Processing Claims of Forged Returns (November 2, 1998), available at *Tax Notes Today*, 1999 TNT 210-69 (November 1, 1999).

d. The IRS will accept an original power of attorney, a photocopy, or a fax copy of a power of attorney as long as authenticity is not reasonably disputed. Previously, the same IRS offices required an individual submitting a power of attorney to send an original. Department of the Treasury, I.R.S. Office of Chief Counsel, Notice N(39)1(10)3-1 (October 22, 1999).

e. Generally, the taxpayer must sign the tax return. However, if the military taxpayer is overseas or incapacitated, the service member can grant a power of attorney to an agent to file and sign the return. I.R.S. Pub. 3.

(1) A power of attorney can be granted by filing Form 2848. While other power of attorney forms may be used, they must contain the information required by Form 2848. I.R.S. Publication 3; *IRS Information Release 91-20* (January 31, 1991).

(2) Joint returns. Generally, joint returns must be signed by both spouses. However, when a spouse is overseas, in a missing status, incapacitated, or deceased, a power of attorney may be needed to file a joint return. I.R.S. Pub. 3.

(a) Spouse overseas. If one spouse is overseas on military duty, there are two options when filing a joint return. One spouse can prepare the return, sign it, and send it to the other spouse to sign early enough so that it can be filed by the due date. Or, the spouse who expects to be overseas on the due date of the return can file Form 2848 specifically designating that the spouse who remains in the United States can sign the return for the absent spouse. I.R.S. Pub. 3.

(b) Spouse in missing status. The spouse of a member of the Armed Forces who is in a missing status in a combat zone can still file a joint return. A joint return can be filed for any year beginning not more than 2 years after the end of the combat zone activities. A joint return filed under these conditions is valid even if it is later determined that the missing spouse died before the year covered by the return. I.R.S. Pub. 3.

(c) Spouse incapacitated. If a spouse cannot sign because of disease or injury and he or she tells the other spouse to sign, the other spouse can sign the spouse's name in the proper space on the return, followed by the words "by [your name], Husband (or Wife)." The cognizant spouse should sign their name in the space provided for their signature. The spouse should attach a dated and signed statement to the return. The statement should include the form number of the return filed, the tax year, the reason the spouse could not sign, and that the spouse has agreed to signing for him or her. Treas. Reg. § 1.6012-1(a)(5); I.R.S. Pub. 3.

(d) Spouse died during the year. If one spouse died during the year and the surviving spouse did not remarry before the end of the year, the surviving spouse can file a joint return for that year, writing in the signature area, "Filing as surviving spouse." If an executor or administrator has been appointed, both he or she and the surviving spouse must sign the return filed for the decedent. I.R.S. Pub. 3.

(e) Filing Returns for Combat Zone Participants

(i) If someone (agent) is acting on behalf of taxpayer serving in a combat zone and the agent does not have a power of attorney from that person specifying that the agent can handle federal tax matters, the IRS will accept a general power of attorney or other statement signed by that taxpayer that authorizes the agent to act on his or her behalf. A copy must be attached to the tax return. I.R.S. Pub. 3; *IRS Information Release 91-20* (January 31, 1991).

(ii) If it is not possible for the spouse of someone serving in a combat zone to obtain that person's signature on a joint return, power of attorney form, or other signed authorization to act on his or her behalf, the IRS will accept a written statement explaining that the husband or wife is serving in a combat zone. The statement must be signed by the spouse filing the tax return and attached to the return. I.R.S. Pub. 3; *IRS Information Release 91-20* (January 31, 1991).

2. Occupation. Instructions for Form 1040 remind taxpayers should include their occupation in boxes next to the signature block.

a. Does taxpayer lists his/her occupation as waiter, cab driver, porter, beautician? If so, IRS may be looking for tip income.

b. Does the taxpayer claim business expenses for an activity that shows no income on the return (i.e., beautician supplies, but no Form 1099 or W-2 for that occupation)? If so, the IRS may find that the return warrants further inspection.

B. Third Party Designee: There is a section to give permission to the IRS to talk to the tax return preparer or other designee and bypass the filer to discuss questions or issues regarding processing related matters on the returns.

1. In the past, tax practitioners (attorneys, CPAs, and enrolled agents) and other paid preparers needed a power of attorney in order to discuss tax return preparation, and refund and payment issues with the IRS.

2. Under this option, the taxpayer's designee has the ability to speak directly to the IRS Customer Service representatives over the telephone and in person in response to math error notices and to receive information about a refund or payment. It should be noted that the authorization **cannot be revoked** by the taxpayer. Nevertheless, the authorization will automatically end no later than the due date (without regard to extensions) for filing the next year's tax return (i.e. 2016 authorization will end April 15, 2018 .

3. The checkbox initiative eliminates the need for the power of attorney only for certain matters. The taxpayer's designee is limited to issues arising during the process of that specific return. The taxpayer will still need to sign a power of attorney for examination matters, under reported income, appeals and collection notices.

4. Military Tax Assistance Programs & checkbox: Military tax assistance programs need to keep in mind that the IRS could attempt to contact a military tax preparer several years after the filing of the tax return. Many military tax assistance programs are only seasonal operations and only a few maintain the same personnel from year to year. Therefore, most military tax assistance programs may not want to check the box.

C. Assembling the return.

1. Where to mail tax returns. Taxpayers should mail tax returns to the address on the envelope received with their tax package, or note the proper mailing address on the back cover of the Form 1040 Instruction Booklet.

2. Volunteer Site Designation. Preparer should ensure that the return accurately reflects that it was prepared by a VITA site and includes the PTIN.

3. Form W-4. The taxpayer should consider making adjustments to their monthly tax withholdings, using Form W-4, if they have an excessive refund or owed a penalty for underpayment of tax.

4. Check for common mistakes.

a. Social security numbers and names. Ensure that the taxpayers' social security numbers and names are accurate by checking the return against the taxpayer's social security card. The IRS tracks the status of returns by social security numbers.

b. Check math. Verify the amounts of taxable income, tax credits, tax payments, and refund or amounts due are accurate.

c. Name and address on return or label. The IRS will use the address on the return to send notices; ensure the taxpayer's reported address is correct.

d. Sign and date return.

e. Attach W-2's.

f. Include payment.

IX. GENERAL INFORMATION.

A. Change of address. The taxpayer can notify the IRS of a change in address by stating the new address on the return, sending Form 8822, making a written statement and sending it to the IRS, or calling the IRS.

B. Record Keeping. In general, taxpayers should keep their returns for as long as the returns may be needed for the administration of any provision of the Internal Revenue Code. In other words, keep the tax returns until the applicable statute of limitations have run. The applicable Statute of Limitations follows:

	IF you...	THEN the period is...
1	Owe additional tax and (2), (3), and (4) do not apply to you	3 years
2	Do not report income that you should and it is more than 25% of the gross income shown on your return	6 years
3	File a fraudulent return	No limit
4	Do not file a return	No limit
5	File a claim for credit or refund after you filed your return	The later of 3 years or 2 years after tax was paid.
6	File a claim for a loss from worthless securities	7 years

C. Amended returns.

1. A taxpayer may file a refund claim on Form 1040X within three years from the time the return was filed, or within two years from the time the taxpayer paid the tax, whichever is later.

2. In determining the time limits within which a refund claim may be filed, the taxpayer may disregard intervening periods of service in a CZ/QHDA, plus periods of continuous hospitalization outside the U.S. as a result of combat zone injury, and the next 180 days thereafter.

D. Copies of Returns. To obtain an exact copy of past tax returns, file Form 4506 (Request for Copy of Tax Return). Cost is $50 per copy.

X. CONCLUSION.

CHAPTER R

DEPLOYMENT TAX ISSUES

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I. REFERENCES

A. Primary.

1. Executive Order 12744.

2. Executive Order 13119.

3. Executive Order 13239.

4. Public Law 104-117.

5. Public Law 106-21.

6. 26 U.S.C. § 112.

B. Secondary

1. IRS Pub. 3, Armed Forces Tax Guide.

2. IRS Pub. 559, Survivors, Executors, and Administrators.

3. IRS Pub. 3920, Tax Relief for Victims of Terrorist Attacks.

II. DEFINITIONS

A. Combat Zone (CZ). A combat zone is an area that the President of the United States has designated by Executive Order as an area where US forces are engaged in combat. A combat zone remains in effect until terminated by Executive Order. (I.R.C. § 112(c)(2)). The current combat zones are as follows:

1. Executive Order 12744 designates the Persian Gulf, Red Sea, Gulf of Oman, Gulf of Aden, the Arabian Sea north of 10 degrees north latitude and west of 68 degrees east longitude, Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates and the airspace above these locations as a combat zone effective 17 Jan 1991.

2. Executive Order 13119 designates the former Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, the Ionian Sea north of the 39th parallel and the airspace above these locations as a combat zone effective 24 Mar 1999.

3. Executive Order 13239 designates Afghanistan, including the airspace above, as a combat zone effective 19 Sep 2001.

B. Qualified Hazardous Duty Area (QHDA). A QHDA is an area that Congress has designated through legislation where the Armed Forces are entitled generally to the same benefits afforded service in a combat zone. The following areas are qualified hazardous duty areas:

1. Public Law 104-117 designates Bosnia and Herzegovina, Croatia, or Macedonia so long as members are entitled to receive imminent danger/hostile fire pay for service in that location as a QHDA effective 21 Nov 1995.

2. Public Law 106-21 designates the former Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, the Ionian Sea north of the 39th parallel and the airspace above so long as members are entitled to receive imminent danger/hostile fire pay for service in that location as a QHDA effective 24 Mar 1999.

C. "In Direct Support."

1. The Secretary of Defense has the authority under Treasury Regulations (currently delegated to PDUSD(P&R)) to extend combat zone tax exclusion benefits (CZTE) to service members performing military service <u>outside</u> of a combat zone or qualified hazardous duty area when the Secretary of Defense determines:

a. Their service directly (as opposed to remotely or indirectly) supports military operations in the combat zone;

b. Their service qualifies them for hostile fire pay or imminent danger pay under 37 U.S.C. § 310; and

c. The reason for paying imminent danger/hostile fire pay is based on risks/dangers related to the QHDA or CZ.

2. Areas Designated In Direct Support of the Afghanistan CZ.

a. Military personnel in Pakistan, Tajikistan, and Jordan effective 19 Sep 2001 and Uzbekistan and Kyrgyzstan effective 1 Oct 2001.

b. Military personnel deployed to the Philippines in conjunction with Operation Enduring Freedom—Philippines effective 9 Jan 2002.

c. Military personnel in Yemen effective 10 Apr 2002.

d. Military personnel in Djibouti effective 1 Jul 2002.

e. Military personnel in Somalia effective 1 January 2004.

3. Areas Designated In Direct Support of Operation Iraqi Freedom. (Note: Operation Iraqi Freedom was renamed Operation New Dawn effective 1 September 2010. This was a change in name only. All designations that referenced Operation Iraqi Freedom continued under Operation New Dawn.)

a. Military personnel serving in Jordan from 19 March 2003.

b. Military personnel serving in Somalia from 1 January 2004.

D. Service in a Combat Zone or Qualified Hazardous Duty Area.

1. The service must be performed on or after the date of designation in the Executive Order issued by the President as the commencement date (or in the legislation in the case of the QHDA) and on or before the termination date in the Executive Order (or the date that members in that country stop receiving imminent danger/hostile fire pay in the case of the QHDA). (I.R.C. § 112(c)(3)).

2. Generally, to receive CZ tax benefits, a member must serve in a CZ or QHDA.

3. Service members outside of a CZ or QHDA receive CZ tax benefits when their service directly (as opposed to remotely or indirectly) supports military operations in the CZ upon the meeting of three basic conditions.

a. First, the direct support of military operations has to have the effect of maintaining, upholding, or providing assistance for those involved in military operations in the CZ (or QHDA). (Treas. Reg. § 1.112-1).

b. Second, the service must qualify the service member for hostile fire pay or imminent danger pay. (Treas. Reg. § 1.112-1).

c. Finally, the reason for payment of imminent danger or hostile fire pay must be based on the risks or dangers related to the QHDA or CZ. DoD Reg. 7000.14-R, "Financial Management Regulation," para. 440103C.5 (Aug 2011). See also Guidance, Office of the Assistant Secretary of Defense Force Management Policy (Military Personnel Policy), subject: Guidance for Requesting/Approving Combat Zone Tax Benefits for Service in "Direct Support" of Military Operations (22 April 1999).

III. TAX FILING OPTIONS FOR DEPLOYING PERSONNEL

A. Filing Before Deployment.

1. If the member has all of the documents and information necessary to file a complete and accurate return, the member may attempt to file the tax return before deploying.

2. A member who chooses to file a tax return early could miss opportunities to reduce taxable income, for example, through making IRA contributions. Therefore, filing before deployment is not always advisable, and tax program volunteers should make the member aware of possible filing extensions.

B. Filing During Deployment.

1. This is the least preferred option. The member's focus in the deployed area should be on fulfilling the mission.

2. Due to constant personnel turnover in deployed areas, maintaining a tax assistance program is difficult. While occasionally there are tax assistance programs in deployed areas, the member may not have access to all documentation necessary to file a complete and accurate return.

C. Authorizing Someone Else to File the Return.

1. Generally, a joint return must be signed by both spouses. Mailing a tax return to the deployed member for signature incurs delays and has the potential for being lost in transit.

2. Power of Attorney. A spouse may sign and file a joint tax return for the deployed member if the spouse has a special power of attorney that contains specific language authorizing the spouse to sign and file the return.

3. IRS Form 2848, Power of Attorney. This form is the IRS power of attorney form and can also be used to authorize a spouse to sign and file a tax return on behalf of the military member. Check the box on line 5a "Sign a return," to allow a spouse to sign the return. Line 5a of Form 2848 should also contain the following statement: "This power of attorney is being filed pursuant to Treasury Regulations section 1.6012-1(a)(5), which requires a power of attorney to be attached to a return if the return is signed by an agent by reason of continuous absence from the United States for a period of at least 60 days prior to the date required by law for filing the return."

4. Statement Attached to the Return. If the military member is deployed to a combat zone or qualified hazardous duty area and the spouse does not have a power of attorney or Form 2848, the spouse can still sign for the deployed military member.

    a. The spouse must attach a signed statement to the return that explains that the member is currently serving in a combat zone.

    b. This option is not available if the spouse and deployed member are filing returns as married, filing separately.

5. Member in Missing Status. If the deployed member is in a missing status, the spouse can still file a joint return for any year beginning not more than 2 years after the end of the combat zone activities.

6. Member Incapacitated. If the deployed member is unable to sign the return because of disease or injury but tells the spouse to sign the return, the spouse may sign the return for the member.

    a. The spouse should sign the deployed member's name, followed by the words "by [spouse's name], Husband (or Wife).

    b. The spouse should also include a signed, dated statement showing the form number of the return, the tax year, the reason the member could not sign and that the member agreed to the spouse signing the return for him/her.

7. Member Died During the Year. If the member died during the year, and if the spouse did not remarry before the end of the year, the spouse can file a joint return for the year.

    a. The spouse should write in the signature area "Filing as surviving spouse."

b. If an executor or administrator has been appointed, both the surviving spouse and the executor or administrator must sign the return.

IV. EXTENSION OF TAX DEADLINES

A. Eligibility. The following individuals are eligible for an extension of tax deadlines:

1. Military members serving in a combat zone or in direct support of a combat zone.

2. Military members serving in a qualified hazardous duty area or in direct support of a qualified hazardous duty area.

3. Military members deployed outside the United States away from the member's permanent duty station while participating in a contingency operation designated by the Secretary of Defense.

4. Spouses of a military member described above.

5. Civilians serving in support of the Armed Forces in a combat zone, qualified hazardous duty area, or contingency operation such as the Red Cross, accredited correspondents, and personnel acting under the direction of the Armed Forces in support of those forces.

B. Actions Extended.

1. Filing any return of income, estate, or gift tax (except employment and withholding taxes).

2. Paying any income, estate, or gift tax (except employment and withholding taxes).

3. Filing a petition with the Tax Court for redetermination of a deficiency or for review of a Tax Court decision.

4. Filing a claim for credit or refund of any tax.

5. Bringing a suit for any claim for credit or refund.

6. Making a qualified IRA contribution.

7. Allowing a credit or refund of any tax by IRS.

8. Assessment of any tax by the IRS.

9. Giving or making any notice or demand by the IRS for the payment of any tax or for any liability for any tax.

10. Collection by the IRS of any tax due.

11. Bringing suit by the United States for any tax due.

C. Length of Extension. The deadlines for the tax actions described above is extended for the following period:

1. 180 days after the later of

a. The last day the member is in the combat zone, qualified hazardous duty area or in direct support of the combat zone or qualified hazardous duty area (or the last day the area qualifies as such); or

b. The last day of any continuous qualified hospitalization for wounds, disease, or injury sustained from service in the combat zone, qualified hazardous duty area, or in direct support of a combat zone or qualified hazardous duty area (qualified hospitalization is hospitalization that resulted from an injury received while serving in the combat zone).

2. Plus the number of days remaining for the member to take action with the IRS when he or she entered the combat zone or qualified hazardous duty area (or in direct support of the combat zone or qualified hazardous duty area).

Example 1: Captain Margaret Jones entered Saudi Arabia on December 1, 2011. She remained there through March 31, 2013, when she departed for the United States. She was not injured and did not return to the combat zone. The deadlines for filing Captain Jones' 2011, 2012, and 2013 returns are figured as follows:

The 2011 tax return. The deadline is January 10, 2014. This deadline is 285 days (180 plus 105) after Captain Jones' last day in the combat zone (March 31, 2012). The 105 additional days are the number of days in the 3 ½ month filing period (January 1 – April 15, 2012) that were left when she entered the combat zone.

The 2012 tax return. The deadline is January 10, 2014. The deadline is 285 days (180 plus 105) after Captain Jones' last day in the combat zone (March 31, 2013).

The 2013 tax return. The deadline is not extended because the 180-day extension period after March 31, 2013, plus the number of days left in the filing period when she entered the combat zone (105) ends on January 10, 2014, which is before the due date for her 2013 tax return (April 15, 2014).

Example 2: A member in the combat zone from 1 October 2012 to 15 January 2013 will have 285 days from the date he leaves the area to file the 2012 return. This extension equals the 180-day extension, plus the 105 days of the tax filing season because he or she was in a combat zone or qualified hazardous duty area on 1 January. **Note -** If a member is serving in a combat zone or qualified hazardous duty area, or in direct support of operations in a combat zone or qualified hazardous duty area, on **1 January**, he or she receives the **full 105 days** of the filing period as part of the deadline extension **even if** the return to home station occurs before 15 April.

Example 3: A member entering a combat zone on 1 February 2012 and serving until 1 May 2013 will have 254 days from the date he leaves the combat zone to file the 2012 return. This period of time is equivalent to the full 180-day extension, plus the 74 days remaining in the filing season when he entered the combat zone or qualified hazardous duty area.

D. Necessary Actions.

1. The extension applies automatically. Neither deployed members nor spouses need to file an extension with the IRS to take advantage of the filing extension granted as a result of qualifying combat zone or qualified hazardous duty service.

2. A member or spouse may notify the IRS that the member is deployed to a combat zone, qualified hazardous duty area, or in direct support of a combat zone or qualified hazardous duty area. The member or spouse can send an email to combatzone@irs.gov and should provide the IRS with the member's name, stateside address, date of birth, and date of deployment. The member or spouse should NOT provide a social security number.

3. If the IRS takes any actions listed or sends a notice of examination before learning that the taxpayer qualifies for a deadline extension, the taxpayer should return the notice with "**COMBAT ZONE**" written across the top. No penalties or interest will be imposed for failure to file a return or pay taxes during the extension period. The IRS, however, will pay interest on a refund from the due date of the return if the return is timely filed after applying the deadline extension.

V. INCOME TAX EXCLUSION

A. Eligibility.

1. The following military members are eligible for the income tax exclusion:

a. Military members deployed to the combat zone or in direct support of a combat zone.

b. Military members deployed to a qualified hazardous duty area.

c. Military members in direct support of a qualified hazardous duty area who are receiving hostile fire pay/imminent danger pay that is directly related to the dangers of supporting the qualified hazardous duty area.

2. The following are NOT eligible for the income tax exclusion:

   a. Civilians serving in a combat zone, qualified hazardous duty area, or in direct support of a combat zone or hazardous duty area. Civilians, as explained above, are only eligible for the deadline extensions, not the tax exclusion.

   b. Spouses of military members.

3. Qualifying service by a military member for one day qualifies the member for the tax exclusion for the entire month.

4. Hospitalization of a military member outside the combat zone or qualified hazardous duty area for part of a month as a result of wounds, disease, or injury sustained while serving in the combat zone or qualified hazardous duty area qualifies the member for the tax exclusion for the entire month.

B. Excluded Income. The following income can be excluded from gross income for income tax purposes. Note: basic pay remains subject to Social Security and Medicare tax.

1. Active duty pay earned in any month the member served in a CZ or QHDA. Enlisted personnel and warrant officers who serve in a CZ or QHDA during any part of a month can exclude all of their basic pay for that month from income. The amount of the exclusion for commissioned officers is limited to the highest rate of enlisted pay. For 2015, this amount is $8,119.50 per month, a figure representing the $7,894.50 payable monthly to the Chief Master Sergeant of the Air Force or Sergeant Major of the Army plus $225.00 for hostile fire or imminent danger pay.

2. Imminent danger or hostile fire pay

3. A dislocation allowance if the move begins or ends in a month the member served in a CZ or QHDA.

4. A reenlistment bonus if the voluntary extension or reenlistment occurs in a month the member served in a CZ or QHDA.

5. Pay for accrued leave earned in any month the member served in a CZ or QHDA.

6. Continuation pay only if the agreement to perform additional years of service is signed by the member in a month when he or she is serving in a CZ or QHDA.

7. Pay received for duties as a member of the armed forces in clubs, messes, post and station theaters, and other nonappropriated fund activities. The pay must be earned in a month the member served in a CZ or QHDA.

8. Awards for suggestions, inventions, or scientific achievements members are entitled to because of a submission they made in a month they served in a combat zone.

9. Student loan repayments made as part of the DoD Loan Repayment Program. Generally, these payments are compensation for services. They are excluded from income during the month(s) the member provides qualifying CZ and QHDA service.

10. The Redux Payment of $30,000. This payment is considered a career service bonus (a type of special pay) available to certain members who execute a written agreement to remain on active duty until completion of 20 years of service and accept a reduced percentage in calculating pay on retirement. Generally, it is taxable income. However, it is excluded from income if the member executes the agreement to receive the payment while providing qualifying CZ or QHDA service.

C. Income Not Excluded.

1. Military pension or retired pay

2. Separation payments.

VI. TAX FORGIVENESS

A. Eligibility. Tax liability can be forgiven if a member of the Armed Forces dies:

1. While in active service in a combat zone or qualified hazardous duty area (including in direct support of military operations in the combat zone or qualified hazardous duty area if the member qualified for hostile fire pay or imminent danger pay),

2. From wounds, disease, or other injury received in a combat zone or qualified hazardous duty area (including in direct support of military operations in the combat zone or qualified hazardous duty area if the member qualified for hostile fire pay or imminent danger pay), or

3. From wounds or injury incurred in a terrorist or military action. A terrorist or military action is any terrorist activity primarily directed against the United States or its allies or any military action involving the U.S. Armed Forces and resulting from violence or aggression against the United States or its allies (or threat thereof).

4. For a member formerly in missing status, the date of death is considered to be the date his or her name was removed from missing status for military pay purposes, regardless of the actual date of death even if it occurred earlier.

B. Tax Forgiven.

1. The decedent's tax liability is forgiven for the year of death and any earlier tax year ending on or after the first day the member served in the combat zone or qualified hazardous duty area.

2. The tax forgiveness only applies to the decedent's portion of any joint income tax liability.

3. In addition, any unpaid tax liability at the date of death may be forgiven.

4. If a decedent's legal residence was in a community property state and the spouse reported half of the military pay on a separate return, the spouse can get a refund of taxes paid on his or her share of the pay for the years involved.

C. How to File.

1. In all tax return filings, the personal representative MUST attach a copy of IRS Form 1310, *Statement of Person Claiming a Refund Due a Deceased Taxpayer*, and a DD Form 1300, *Report of Casualty*.

2. The personal representative should also include an attachment that shows a computation of the decedent's tax liability before any amount is forgiven and the amount to be forgiven.

3. For any unfiled tax years, the personal representative should file Form 1040 and attach the Form W-2. At the top of page 1 of the return and on the line for Total Tax, the personal representative should write the name of the operation and the abbreviation "KIA" or "KITA". For example, "Operation Enduring Freedom – KIA", "KITA – 9/11" (Killed in Terrorist Action – 9/11).

4. For any eligible but previously filed tax years, the personal representative should file Form 1040X. At the top of page 1 of the return and on the line for Total Tax, the personal representative should write the name of the operation and the abbreviation "KIA" or "KITA".

5. The returns and claims must be filed at Internal Revenue Service, 333 W. Pershing, Stop 6503, P5, Kansas City, MO 64108.

D. When to File. Generally, the period for filing a claim for credit or refund of income tax is 3 years from the time the return was filed or 2 years from the time tax was paid, whichever is later. Where death occurred in a combat zone or qualified hazardous duty area, or from wounds, injury, or disease incurred in these areas, the deadline for filing a claim for credit or refund is extended. The extension period is 180 days plus the time remaining in the 3- or 2-year claim period (whichever is applicable as yielding the later filing date) when the decedent member entered the combat zone or qualified hazardous duty area.

VII. CONCLUSION.